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PREPARATION FOR THE 1990 FARM BILL

HEARINGS

BEFORE THE

SUBCOMMITTEE ON AGRICULTURAL CREDIT

OF THE

COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

THE CREDIT TITLE OF THE 1990 FARM BILL AS IT RELATES TO THE FARMERS HOME ADMINISTRATION AND TO THE FARMERS HOME ADMINISTRATION'S GUARANTEED LENDING PROGRAM AND THE IMPLEMENTATION OF THE AGRICULTURAL CREDIT ACT OF 1987 BY THE FARMERS HOME ADMINISTRATION

FEBRUARY 8 AND 20, 1990
MARCH 5, 1990

PART IX

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PREPARATION FOR THE 1990 FARM BILL

Credit Title of the 1990 Farm Bill As It Relates to the Farmers Home Administration

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THURSDAY, FEBRUARY 8, 1990

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL CREDIT OF THE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:05 p.m., in room SR-332, Russell Senate Office Building, Hon. Kent Conrad (chairman of the subcommittee) presiding.

Present or submitting a statement: Senators Conrad, Boschwitz, and Gorton.

STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. I want to welcome everyone to this hearing.

I am Senator Kent Conrad, and this is the first hearing of the Subcommittee on Agricultural Credit on the credit title of the 1990 farm bill as it relates to the Farmers Home Administration.

I want to welcome my colleague, Senator Gorton. I will begin with a statement and then we will ask Senator Gorton if he has a statement that he would like to make. Then we will go to the witnesses. We have a full slate this afternoon.

This is a very important hearing, one of a series that we will be holding in preparation for the credit title of the 1990 farm bill. Obviously a good deal of attention is going to be focused on this title as we attempt to cope with the problems resulting from the difficulties we have had in the farm economy over the last decade.

Today we begin the process of reviewing FmHA's programs. The purpose of this first hearing is to review FmHA's programs, its mission, and its performance in serving that mission. We will specifically address the need for FmHA credit, the impact of the shift from direct to guaranteed lending, FmHA's role as a supervised creditor, and FmHA's graduation and borrower training processes.

This is, as I indicated, the first of a series of four hearings on the credit title of the 1990 farm bill. On February 13, I will travel to North Dakota for a field hearing.[1] On February 20, we will hold a hearing in Washington specifically on the guaranteed lending program, and on March 5, we will review the implementation of the Agricultural Credit Act.

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[1] The second hearing held on February 13, 1990, "FmHA Issues Relating to the Credit Title of the 1990 Farm Bill," the Heritage Center Auditorium, Bismarck, ND, at 9:30 a.m., and chaired by Senator Conrad. This hearing was not printed and is retained in the subcommittee file.

FmHA and its borrowers have gone through major upheavals in the last decade and since the 1985 farm bill was passed. American farmers were hit by a farm depression which dropped land values by 50 percent and reduced net farm income to its lowest level since recordkeeping began in 1910. According to USDA, this depression in the farm economy reduced the real value of total farm assets by some $400 billion—almost 50 percent—between 1981 and 1987.

The farm depression hit FmHA as well. As farm income fell, borrowers became delinquent, and as land values fell, borrowers became undercollateralized. At the beginning of the 1980's, FmHA had two disaster loan programs with very loose lending criteria. By 1987, these programs—the Economic Emergency and Economic Disaster Loan Programs—accounted for two-thirds of FmHA's delinquent debt. To add to this pressure, new programs were added to FmHA's portfolio, and old programs changed. Over the decade, total FmHA's obligations due to these and other farm programs have increased.

Some States are beginning to recover from the farm depression. My home State of North Dakota, unfortunately, is not. We have had two devastating droughts, and the prediction is that this crop-year will be no better. We, perhaps, will face a third. FmHA lending programs are very important to States such as mine. Even farmers in States which did not experience the drought but did experience the farm depression still need temporary assistance to move toward recovery.

FmHA and the farm economy are slowly recovering from the depression and turmoil of the 1980's. The dust is beginning to settle as much of FmHA's long-term delinquent loans have been serviced or otherwise resolved. As normalcy returns, it is now time to begin reassessing the agency's purpose and performance.

The 1985 farm bill decreased authorizations for direct loan programs and increased authorizations for guaranteed loans. As a result, there has been a dramatic shift from the direct loan program to guaranteed lending, beyond what was authorized in the farm bill. Funding for direct loans has dropped 77 percent since 1985, and authorizations for guaranteed loans have more than doubled. This shift in funding has resulted in a 65 percent drop in operating loans made by FmHA, and a 59 percent drop in Farm Ownership loans made. Has the shift from direct to guaranteed loans been successful?

In 1989, FmHA received three times the number of applications for direct loans as for guaranteed loans. Is the balance in funding between direct and guaranteed appropriate to demand, or has the shift gone too far?

Are borrowers graduating from FmHA credit to private lenders? If not, is it the fault of the farm recession of the 1980's or are there other reasons? Is FmHA helping to prepare beginning farmers for commercial credit by supervising and assisting in their farm management training? If not, should we return FmHA to its role of supervised creditor?

Are FmHA's loan assessment and data collection procedures adequate to aid FmHA and Congress in judging whether its goals are being met?

Does the current eligibility criteria for the programs prevent the kind of loose lending that occurred in the 1970's and early 1980's through the Economic Emergency and previous versions of the Emergency Disaster Loan Programs that I mentioned earlier? These programs constituted 78 percent of the debt that was over 4 years delinquent when the Agricultural Credit Act was passed in 1987. While they were intended to help borrowers survive economic disasters, I think we have learned that they actually hurt the borrowers in the long run.

These are tough issues. The answers are not always clear. What is clear is that there will continue to be a need for FmHA credit as long as low commodity prices and high interest rates prevail. I hope that we can begin to answer some of the questions I have raised today.

Before we begin, I would just like to take a moment to discuss some misstatements we have heard through the media and the administration about enormous losses to FmHA, particularly due to the Agricultural Credit Act of 1987. While I had not intended to discuss the act at this hearing, I do feel the need to set the record straight.

FmHA will not "lose" $22 billion over the next several years due to the Agricultural Credit Act. Those who have cited that number are misleading the public, perhaps inadvertently, but nonetheless I believe they are misleading the public. Some critics of the program are combining the FmHA losses recognized by write-downs and write-offs with interest subsidies, and property management expenses.

First, according to the Congressional Budget Office, the cost of the Agricultural Credit Act of 1987 is slightly over $100 million per year for 4 years. The billions in losses that are getting attention are losses which existed prior to the act. Congress passed the act to force FmHA to resolve these delinquencies. In fact, the act specifically requires FmHA to foreclose on delinquent loans if foreclosure will return more money to the Treasury than will restructuring.

When Congress passed the Agricultural Credit Act, FmHA estimated that it had over $8.7 billion in losses. The actual "cost" of recognizing previously incurred losses from fiscal years 1989 through 1991 is $5.4 billion. Again, I want to reiterate that these losses had already occurred by the time Congress passed the act, which forced FmHA to recognize the losses and resolve the delinquencies. Losses from delinquencies, including accrued interest, would have been much greater if FmHA had been allowed to continue to refuse to service these loans.

I want to add one further statement, and that is that clearly the credit title is going to be among the most controversial that we will address as we pursue the farm bill of 1990. I very much hope that all of us will work together to try to resolve the outstanding problems. Thus far, I have had a good working relationship with the new Administrator of FmHA. I think we will certainly have an opportunity to address some of the problems that have been identified. We have a full set of hearings that have been scheduled so that we have an opportunity to address the outstanding concerns that remain to be resolved.

Let us begin.

I would turn to my colleague, Senator Gorton, for any opening statement that he might have.

STATEMENT OF HON. SLADE GORTON, A U.S. SENATOR FROM WASHINGTON

Senator GORTON. Mr. Chairman, I simply want to say that your opening statement bodes well for the cooperative process you asked for in ending it. I have listened to it with great care. I think you set out accurately and dispassionately the kind of questions with which we are going to be faced, the questions that we ought to be faced with, and I do want to congratulate you on what I consider to be a very good beginning to these hearings. And certainly after four hearings we ought to have enough background information so that we can begin to make good, objective decisions.

I am not going to be able to return after this vote due to a conflict. I can tell Mr. Johnson that I have had an opportunity to read his statement. His is an ambitious agenda, I think we can safely say. And yet it also raises these fundamental questions about what the Farmers Home Administration is about: what kind of constituency it ought to be serving, how directly it ought to be involved in that service, the extent to which it should be engaged in activities other than simply monetary activities? This 1990 farm bill gives us the opportunity to do exactly that, to try to see to it that at the same time we get a more responsive and a more helpful Farmers Home Administration without huge, immense and irrecoverable costs to the general taxpayer.

Your sensitivity toward these new stories shows the general taxpayer is implicated in these policy decisions, and we must consider responsible fiscal policy as well as responsible farm policy, but at the very least, Mr. Chairman, I think you have made a good beginning.

Senator CONRAD. Thank you, Senator Gorton. Senator Boschwitz, there is a vote on. You may begin your opening statement, or we may recess now for the vote and then return whatever your wish.

STATEMENT OF HON. RUDY BOSCHWITZ, A U.S. SENATOR FROM MINNESOTA

Senator BOSCHWITZ. Mr. Chairman, I will not be able to join you for the balance of the hearing. We should look carefully at the FmHA, and I look forward to the analysis that you will make. I know that you will do so with your customary thoroughness. And you are thorough.

Let me tell you that my attitude with respect to the FmHA is that it should apply first, foremost and almost principally to young farmers who want to get into the business who need help in getting into the business.

Frankly, I find the record of the FmHA somewhat discouraging. On the 30th of September I am told that the outstanding principal for direct loans is $23 billion and that delinquencies are $11 billion of the $23 billion. The direct loans in which there has not been any activity for more than 4 years amount to approximately $7 billion, most of which are the emergency loans. Approximately 60,000 borrowers hold these loans. About one-third of all the direct loan borrowers from the FmHA are delinquent. And as I say, most of them have been delinquent for an extended period of time.

On the other hand, the guaranteed loan program has a far better record. It has outstanding loans and principal of about $3.2 billion. Only about 6 percent of them are delinquent. Considering the type of loans that are made, and the type of credit elsewnere, tests that are involved, that is not too bad in my judgment. I think it also indicates that the Government is not a particularly good collector of overdue debts. Of course, they have been hung up with lawsuits, some of which have emanated from your State. I, therefore, am also more inclined toward guaranteed loans or buying down interest. It's not as hard a hit on the budget because every penny of a direct loan is an outlay.

So I am for guaranteed loans. I am for loans where the interest rate is paid down to some degree by the Federal Government. The guaranteed loans need not be guaranteed 100 percent. I like the approach taken by the Small Business Administration, so that the bank has an interest in collecting as well. As I understand it the expected losses of $10.5 billion, discussed yesterday in this committee, are not all loan write-downs.

That is the attitude I bring toward this subject as a member of this subcommittee and as a member of this committee. I am very cognizant of the difficulties that young people have in getting into the business of farming, and the FmHA should indeed be active in assisting beginning farmers.

Senator CONRAD. I might just alert my colleague that, as I understand about $6.4 billion of the $10.5 billion that we learned of yesterday is actually in the farm programs. There is another $4 billion that are in other programs. So I think part of what we heard yesterday may have been somewhat confusing.

Senator BOSCHWITZ. I understand.

Senator CONRAD. We will have a recess now and go back and vote and return, and then we will hear from Sox Johnson, the Administrator of FmHA. The subcommittee stands in recess.

[Recess.]

Senator CONRAD. The subcommittee will come to order. I want to welcome the Acting Administrator, Neal Sox Johnson of Farmers Home Administration and thank him for his cooperation, thank him also for the attitude that he has brought to the job. I am certain there will be times we disagree, but I think the common spirit of wanting to get at FmHA's problems and resolve issues and move ahead is one that we share and I very much look forward to working with you on these issues. So, again, welcome, Mr. Johnson, and if you will proceed with your testimony. Then we will have a chance for some questions and move on to the other witnesses.

STATEMENT OF NEAL SOX JOHNSON, ACTING ADMINISTRATOR, FARMERS HOME ADMINISTRATION, U.S. DEPARTMENT OF AGRICULTURE, WASHINGTON, DC; ACCOMPANIED BY GLENN J. HERTZLER, JR., PROGRAM OPERATIONS, ASSISTANT ADMINISTRATOR FOR FARMER PROGRAMS

Mr. JOHNSON. Very good.

INTRODUCTION

Before I proceed with my prepared statement, let me compliment you on your opening statement and certainly the comments by Senators Gorton and Boschwitz, I thought we had a very good beginning there. So I too am pleased with those statements.

I do thank you for this opportunity to appear before you and set forth our recommendations for the 1990 farm bill.

ROLE OF FMHA

For most of the 50-year-plus history, the Farmers Home Administration (FmHA) and its predecessor agencies took pride in administering a traditional program as a temporary source of credit, supervised credit, to help farmers in trouble get over their rough patches, back on their feet and operating with conventional credit.

WE HAVE STRAYED FROM THAT ROLE

We have strayed from that role. We have emphasized loanmaking at the expense of supervision and collection. The program has evolved into a permanent source of comprehensive, government-subsidized credit. For too many of our borrowers it has become a way of life.

We have all paid the price. We can no longer continue to do so. Not the farmer who sees his remaining equity erode under additional debt. Not the taxpayer facing the certainty of continuing budget deficits. Now is the time to return to our original role, particularly with the farm economy on the mend.

WE PROPOSE TO DEFINE OUR ROLE

We propose to do that, Mr. Chairman, to define our role in a manner more consistent with our traditional mission: providing limited-term supervised credit to borrowers who have a reasonable chance of becoming successful farmers and assisting them in making the transition to commercial credit.

THE FARM LENDING PROGRAM IS IN DEEP TROUBLE

We come before you today with the farm lending program that is in deep trouble. It is in trouble from the standpoint of the borrower, with half of our $27 billion in direct loans outstanding owed by delinquent borrowers.

And it is in trouble from the standpoint of the Government—the taxpayer if you will—with the Farmers Home Administration's accumulated deficit standing at $42.6 billion, according to the General Accounting Office, including losses of $13.8 billion in fiscal year 1988 alone. Do let me add here at this point, Mr. Chairman, that the $42.6 billion is for all programs of the agency. I want to make that clear so it is agency-wide programs; however, farm programs are almost three-fourths of that amount. So it is considerable under any scenario.

THE 1990 FARM BILL IS A GREAT OPPORTUNITY TO DO WHAT NEEDS TO BE DONE TO GET THIS PROGRAM BACK ON TRACK

Mr. Chairman and members of the subcommittee, the 1990 farm bill is a great opportunity to do what needs to be done to get this program back on track. We got a good start with the 1985 Food Security Act, in dealing with emergency-type loans which represent the largest single source of delinquency today. We cut back on the open-ended eligibility by imposing loan-size limitations, and I must add that also started back as early as 1980. However, through the years, we did make some substantial progress there and by restricting eligibility to family-size farmers, and we discussed this before. So I have to ad lib again. Family-size farmers are the ones that we feel we are best equipped and need to deal with, and we think it is more in line with our mission rather than large corporate farmers, and I think we are in agreement on that point. With the 1987 Agricultural Credit Act, we developed the means to deal in a compassionate way with borrowers who got in trouble as a result of the downturn in the farm economy for much of the past decade.

OUR FIRST TASK IS TO DETERMINE WHETHER, IN SECRETARY YEUTTER'S OFT-STATED TERMS, THE FARMERS HOME ADMINISTRATION IS TO FUNCTION AS A LENDER RATHER THAN A GRANT AGENCY

Much remains to be done today. I suggest that our first task is to determine whether, in Secretary Yeutter's oft-stated terms, the Farmers Home Administration is to function as a lender rather than a grant agency. Assuming you agree, our task is to identify those borrowers who are to be assisted with the limited resources available to us.

WE HAVE SOME PROPOSALS

We have some proposals toward that end for your consideration, Mr. Chairman, which we regard as a forward-looking model for the future, building on the experience and innovations of recent years.

We would rely on much greater participation in guaranteed lending by private and cooperative credit sources, coupled with new strategies to expand acceptance of guarantees among borrowers and lenders alike. Our overall package also includes some modifications to take into account particular needs of our existing borrowers, the beginning farmer, and the socially disadvantaged.

SOME SPECIFICS

Now let me flesh this out with some specifics. In the area of direct operating (OL) loans, we see a need to target these loans to where they are most needed, where they will do the most good, and where FmHA supervision can really make a difference. We would therefore place emphasis on beginning farmers who would become operators for the first time. We would require a combination of farm production and business-related education and work experience during 3 of the 5 preceding years, including at least a year of farm work experience.

We also would limit eligibility of new direct operating loan borrowers to a total of 7 years. Assuming a borrower received a 7-year equipment loan as late as year 7, the maximum he could remain with FmHA would be 14 years.

We would continue to provide interest assistance tailored to the needs of the direct-loan borrower based on cash-flow capability, down as far as the FmHA limited resource rate, and initiate an annual review requirement.

Our proposed new policies and procedures, including the interest rate assistance, would apply to all new loans to both current and new borrowers. A former borrower who came back to us for new loans would be subject to the new rules. However, there would be no modification of rates, terms and other conditions that were contained in their old loans.

Our proposals for guaranteed operating loans would emphasize assistance to the experienced farmer. We would modify the program to make it easier for a direct loan borrower to make the transition to conventional credit. We also would continue to use the guarantee program to assist current borrowers of private lending institutions who could no longer remain with those lenders on conventional terms, but qualify as an acceptable risk with a guarantee.

A limitation would be imposed on the number of years a borrower could qualify for a guarantee, a total of 7 years. We also would impose a requirement that the borrower have a minimum equity of 20 percent in the operation except that this requirement would not apply in the case of a direct loan borrower moving over to the guarantee.

Overall, we propose a 10-year maximum period during which any borrower could obtain a combination of new direct and guaranteed annual operating loans. With a one-time rescheduling of up to 7 years permitted under the direct and guaranteed loan programs, we would effectively cap at 17 years the number of years a farmer would be with FmHA.

Direct farm ownership loans would be targeted to socially disadvantaged applicants, those given specific emphasis under the Agricultural Credit Act of 1987. In addition, inventory property sales will provide an ample opportunity for farm ownership to other eligible family farmers.

We are also proposing several modifications to the guaranteed farm ownership program, limiting eligibility to borrowers who would become owner/operators for the first time and those wishing to expand family farms.

These are the highlights, Mr. Chairman. The details are provided in excerpts from the administration's 1990 farm bill proposal appended to my testimony. You will find that it reflects certain policies throughout: an end to perpetual eligibility, and targeting of assistance to those most in need.

This proposal should result in a new era of sustainable family farm operations capable of withstanding the shocks and downturns that inevitably will occur at times in the future.

Two other aspects deserve mention, Mr. Chairman. One is that we propose to work with private sector lending institutions in developing common terminology, forms, practices and principles, as well as joint training and seminars. Our intent is both to foster participation of private lenders in the guarantee program and to work toward more prudent and professional approaches to loanmaking and servicing.

Our objective is to adapt appropriate lending practices to assure that loans made to our borrowers are made and serviced to provide reasonable prospects for success.

The other item is that we are seeking language which will make it possible for the Federal Agricultural Mortgage Corporation, Farmer Mac, to provide the secondary market mechanism for pooling loans guaranteed by the Farmers Home Administration.

Before I conclude, Mr. Chairman, I have one final point. We also have several proposals that are intended to curb certain program abuses relating to the restructuring provisions of the 1987 Agricultural Credit Act, certainly as we have discussed before. Since you have scheduled a hearing on the 1987 act for March 5, I shall not detail these proposals today, but will look forward to discussing with you at the appropriate time.

That does conclude my prepared testimony, Mr. Chairman. I look forward to answering any questions which you and the other members may have. Thank you.

I would like to acknowledge that I have asked, if it is permissible with you, I would like to have Jack Hertzler, our Assistant Administrator for Farmer Programs, sit beside me here.

Senator CONRAD. Absolutely.

Mr. JOHNSON. But we look forward to taking your questions and certainly working with you.

[The proposal of the Administration's 1990 farm bill, VI. Farm Credit in Brief, follows:]

VI. Farm Credit in Brief

Administration proposals in the farm credit area are intended to provide for better targeting of Farmers Home Administration (FmHA) farm operating and farm ownership loans, and to curb certain program abuses regarding the restructuring provisions of the Agricultural Credit Act of 1987. The proposals will permit FmHA to return to its traditional role as a supervised lender.

Under the proposals, eligibility for direct FmHA operating loans would be limited to seven years. Borrowers would remain eligible for up to 10 years when receiving assistance through a combination of direct and guaranteed loans. Any loan restructuring would have to be done within this 10 year period, and the length of restructured loans would be limited to seven years, effectively limiting the number of years borrowers could remain with FmHA to 17 years.

Further, a 20 percent equity requirement would be established for guaranteed loans and the guarantee on farm ownership loans would be limited to 15 years.

The Administration is also proposing that FmHA guaranteed loans, including operating loans, be eligible for participation in the Farmer Mac secondary market that is being established under the Farm Credit System. This proposal will avoid having FmHA establish a separate market, and should be a substantial encouragement to private lenders to work with FmHA in making guaranteed loans.

Direct farm ownership loans would be limited to socially disadvantaged applicants, as defined under the Small Business Act. Maximum indebtedness on direct farm operating loans would be reduced from $200,000 to $100,000. Other proposals would require experience in order to qualify for direct loans, prohibit use of direct loans to refinance existing debt, impose a needs test for limited resource loans, provide for the use of forms and standards consistent with the private sector, and terminate the continuation loan policy.

Proposals to curb abuses under the Agricultural Credit Act of 1987 include limiting debt write-downs to a one-time event and restricting eligibility for such write-downs to loans made prior to the Act of 1987, broadening the recapture provision on loan buy-outs so that they are consistent with the provisions that already apply to debt write- downs, providing for the denial of buy-outs where the borrower has not acted in good faith, imposing a $250,000 limit on write-downs and write-offs, providing that all assets can be considered in the calculation of write-downs and write-offs, allowing FmHA sales of inventory property at market rather than capitalization value, and extending the time periods for FmHA borrowers to respond between steps in the loan structuring process.

1. Direct Farm Operating Loans

Issue:

Target direct farm operating loans to existing borrowers and beginning farmers and limit time eligibility of borrowers.

Background:

Direct operating loans first reached the billion-dollar level in fiscal year 1982, and peaked at $4.7 billion in fiscal year 1985. There has been a sharp reduction in the years since, with $900 million available in fiscal year 1988 and $932.5 million in fiscal year 1989 (the increase resulting from a supplemental appropriations item of $32.5 million). Actual obligations were $899 million or 99.9 percent of amounts available in fiscal year 1988, and $856 million, or 91.8 percent of the increased amount available in fiscal year 1989. The 1990 Appropriation Act provides $900 million; $32.5 million in carry-over funds also is available. The President's budget for fiscal year 1991 includes $500 million.

Availability of guaranteed operating loans has increased from a negligible level in the early 1980s to $2.15 billion and $2.6 billion in fiscal year 1988 and 1989, respectively, with obligations of $891 million and $879 million.

The reduction in direct loans and shift to guaranteed loans was endorsed by Congress in the Food Security Act of 1985. In addition, Congress enacted a continuation policy as part of the Supplemental Appropriations Act for 1987 which requires the Agency to make annual production loans to borrowers who are delinquent on other loans and who can demonstrate an ability to cash flow on only that new loan. A similar program was initiated administratively during the early 1980s at a time when it appeared that the economic distress affecting borrowers might be of shorter duration than proved to be the case. FmHA discontinued the policy in late 1985 in the face of mounting delinquent debt and declining value of borrower security. There were 238 such loans representing obligations of $8.8 million outstanding at the end of fiscal year 1989.

Recommendation:

Restrict direct operating loans to existing borrowers and to beginning farmers who would become operators for the first time.

a. Limit maximum operating loan indebtedness to FmHA to $100,000 at any one time. The current limit is $200,000.

b. Require education or work experience, including at least one year of farm work, during three of the preceding five years before direct operating loans are approved.

c. Prohibit refinancing of existing debt.

d. Limit eligibility for direct farm operating loans to a total of seven years. A borrower could still receive a seven-year equipment loan as late as the seventh year of eligibility and thus remain with FmHA for a total of 14 years.

e. Impose a 10-year maximum on the period during which an applicant could obtain any combination of new direct and guaranteed annual production loans and a one-time restructuring of up to seven years permitted within the 10-year period of eligibility. This would effectively cap at 17 the number of years a farmer would be with FmHA. To illustrate, a borrower receiving seven annual direct operating loans followed by three annual guaranteed operating loans would remain with FmHA for the maximum 17 years by obtaining a seven-year restructuring of his guaranteed debt in year 10.

f. Use underwriting forms, standards, practices and terminology consistent with the private sector to the maximum extent possible.

g. Discontinue continuation loans.

2. Guaranteed Farm Operating Loans

Issue:

Future role of guaranteed operating loans.

Background:

While the authority for guaranteed farm operating loans has increased dramatically, obligations have fallen far short of authorized amounts - 41.4 percent in fiscal year 1988 and 33.8 percent for fiscal year 1989. Many states, including some with impressive obligations of guaranteed farm ownership loans, obligate only a fraction of their guaranteed operating loan authority.

This has led to pressure from Members of Congress, including some sympathetic to the objective of the direct-to-guaranteed policy shift, to press for an increase in direct operating funds out of concern for credit availability in their states. Clearly, full acceptance of guarantees remains a problem with lenders, borrowers, and — to some extent — personnel of the Farmers Home Administration. Additional incentives may be necessary, going beyond the interest rate buy-down program initiated under the Food Security Act of 1985, if guarantees are to replace a larger portion of direct lending.

The President's budget for fiscal year 1991 provides for $2.6 billion in guaranteed farm operating loans; $350 million of this amount would be subsidized an average of 3 percent in interest.

Recommendation:

Modify the guaranteed farm operating loan program: 1) to facilitate the transition of existing direct loan borrowers to guaranteed loans and ultimately to private sector credit; and, 2) to provide a source of assistance to current borrowers of private lending institutions who can no longer continue with those lenders on commercial terms. Specifically:

a. Require that no borrower may receive such guaranteed loans for more than seven years.

b. Impose a 10-year maximum on the period during which an applicant could obtain any combination of new direct and guaranteed annual production loans and a one-time restructuring of up to seven years permitted within the 10-year period of eligibility. This would effectively cap at 17 the number of years a farmer would be with FmHA. To illustrate, a borrower receiving seven annual direct operating loans followed by three annual guaranteed operating loans could remain with FmHA for the maximum 17 years by obtaining a seven-year restructuring of his guaranteed debt in year 10.

c. Require the borrower to have 20 percent equity in the operation, except when refinancing from direct loans.

3. Direct Farm Ownership Loans (FO)

Issue:

Redirect the direct farm ownership lending program to socially disadvantaged applicants as described in the Agricultural Credit Act of 1987.

Background:

The Congress has been scaling down funding for direct farm ownership loans in recent years, particularly as a result of the general shift from direct to guaranteed loans initiated by the Administration and given impetus under the Food Security Act of 1985. From a peak of nearly $1 billion in 1980, direct FO obligations have, with minor year-to-year variations, trended downward to a level of $115 million in fiscal year 1988 and $95 million in fiscal year 1989. The level provided in the appropriation bill for fiscal year 1990 is $80 million. The President's budget for fiscal year 1991 provides for a program level of $38.5 million.

The Agricultural Credit Act of 1987 gave special emphasis to members of socially disadvantaged groups by establishing FmHA's Target Participation Program designed to assure such applicants a share of farm ownership loan funds and an opportunity to purchase farmland in the Agency's inventory. The Act provides that "socially disadvantaged" be defined consistently with section 8(a)(5) of the Small Business Act (generally, racial and ethnic minorities).

Recommendation:

Limit new direct farm ownership loans to socially disadvantaged applicants. Impose a loan limit of $150,000 per borrower. Use underwriting forms, standards, practices and terminology consistent with the private sector to the maximum extent possible.

4. Guaranteed Farm Ownership Loans

Issue:

How to allocate guaranteed farm ownership loans.

Background:

The guaranteed farm ownership program went from a negligible level in fiscal year 1983 to $361 million in fiscal year 1988 and $299 million in fiscal year 1989. The fiscal year 1990 appropriation is $475 million. The President's budget for fiscal year 1991 provides for a program level of $150 million, $50 million of which would be subsidized at an average of 3 percent in interest. It is therefore appropriate to target beginning farmers and those who wish to expand family farms.

Recommendation:

Provide guaranteed farm ownership loans to:

a. Those who would become owners for the first time, with the following provisions:

   (1) Limit the FmHA guarantee to 15 years. Loans may have a longer amortization schedule at the option of the lender.

   (2) Require three years of actual farm experience, such as work on the family's farm, work as a farm employee, or experience as operator of a rented farm, within the most recent five years.

   (3) Require a 20 percent down payment or 20 percent equity.

b. Those who wish to expand family farms, with the following primary provisions:

   (1) Require a 20 percent down payment or 20 percent equity, except when refinancing from direct loans.

   (2) Require that the operation not exceed family size after expansion.

   (3) Prohibit the use of loan proceeds for refinancing of existing debt, except when refinancing from direct loans.

5. Debt Write-Down

Issue:

How to limit loan restructuring with debt write-down.

Background:

Existing law imposes no limitation on the number of times a borrower can go through restructuring with write-down of debt. This raises the very real possibility that the same borrower can be restructured, again become delinquent, and go through the whole process again with continuing eligibility for debt write-down or net recovery buy-out. This could easily occur if the net recovery value of the security continued to decline, so that with each restructuring calculation, its net recovery value would be less than payments on the newly restructured debt.

The Agricultural Credit Act of 1987 was enacted as a response to the huge backlog of delinquency which Farmers Home was unable to deal with because of judicially imposed constraints and the precipitous drop in the value of farmland securing the delinquent debt. Improvements in the farm economy and the stabilization — and in some cases upturn — in farm real estate values obviate the need for a drastic measure such as write-down. The normal servicing options provided by FmHA for decades are sufficient protection once implementation of the Act has completed providing protection to borrowers affected by the extraordinary events of the 1980s. Elimination of these options would serve as an incentive to new borrowers for prudent borrowing and farm management.

Language limiting the write-down to one per borrower was contained in the original Senate-passed versions of the Agricultural Credit Act of 1987 but was dropped in conference.

Recommendations:

a. Limit the number of times a borrower can writedown debt to one.

b. Provisions of the Agricultural Credit Act of 1987 to restructure debt (write-down, net recovery buy-out, etc.) will not apply to loans closed after January 6, 1988.

6. Buy-Out

Issue:

How to better recapture net recovery buy-out losses.

Background:

Existing law limits recapture by FmHA under net recovery buy-out to the difference between net recovery value and market value of the property subject to the buy-out. The market value is determined at the time of the buy-out. Recapture is available only if the property is sold at a gain within two years of the buy-out. There is no recapture based on appreciation in value of the property over time, and no recapture whatever if the former borrower waits two years and a day before selling or sells within two years at net recovery value.

The stated intent of the Act was to keep farmers in operation, if at all possible, by writing down debt (as far as net recovery value if necessary) to structure an operation that will cash flow, provided the cost to the Government would not exceed losses through liquidation. Borrowers who receive restructuring with debt write-down must enter a shared appreciation agreement whereby Farmers Home recoups certain sums when the borrower sells the property, pays off his loan or discontinues farming. The percentage of appreciation recaptured varies with the number of years before shared appreciation is triggered.

While the farmer remaining in operation under the debt restructuring must share asset appreciation with FmHA for 10 years, the borrower who sells after buy-out may easily avoid any recapture at all. This represents an inducement for the former borrower to hold on to his property for two years and then sell out, or sell at recovery value within the two years under a collusive arrangement whereby he in fact realizes a gain not shared with the Government.

Recommendations:

Extend the recapture period to 10 years. Compute recapture on the difference between net recovery value and the market value of the property at the time of sale.

7. Good-Faith Dealing

Issue:

Resolving inconsistent requirements for good-faith dealings.

Background:

Net recovery buy-out is available to those borrowers who have been considered for loan restructuring (including debt write-down to net recovery value of collateral) and found ineligible. Unlike the case with loan restructuring/write-down, there is no requirement under net recovery buy-out that the borrower has dealt in good faith with the Secretary in meeting obligations in connection with the FmHA loans. FmHA has no authority under the law to deny net recovery buy-out on the basis of even the most blatant instance of bad faith.

The Office of Inspector General has urged FmHA to "seek such legislative remedies as necessary to explicitly preclude those who demonstrate a lack of good faith from participating in any of the Agricultural Credit Act's provisions." Under existing authority, the agency can deny the benefits of most servicing actions to borrowers who have not dealt in good faith, the principal exceptions being net recovery buy-out and preservation servicing which, in the case of buy-back of inventory property, can entail extension of further credit.

Continuing to provide program benefits to those who fail to deal in good faith makes a mockery of FmHA's requirements and invites further abuses.

Roughly 400 cases a year of illegal disposition of property pledged to FmHA have been accepted for investigation by the Office of Inspector General. Many more cases are rejected or not even reported by FmHA field staff because of the difficulty in justifying an investigation, much less prosecution. In addition to conversion of security, other bad faith problems include falsification of documents and failure to comply with written agreements with the agency.

Recommendations:

Impose a good-faith requirement as a condition of eligibility for net recovery buy-out and preservation servicing. Impose a requirement that the value of all assets listed on security agreements be included even if they have been disposed of by the borrower without FmHA consent.

8. Debt Forgiveness Limitations

Issue:

Should there be a maximum amount of debt which can be forgiven?

Background:

FmHA is writing off huge amounts of debt under the Agricultural Credit Act of 1987. Almost 100 borrowers have received a write-down or write-off of $1 million or more in 1989, one exceeding $5 million.

Huge write-offs tend to discredit FmHA and serve as a disincentive for borrowers to meet their obligations to FmHA.

Recommendation:

Impose a $250,000 dollar limitation on the amount of write-down or write-off given a single borrower.

9. Assets

Issue:

How should borrowers' assets that have not been used to secure FmHA loans be taken into account in write-down or net recovery buy-out?

Background:

Under existing law, FmHA must consider only property securing the agency's loans in calculating amounts to be written down or written off. It must ignore other assets such as other farm or nonfarm real estate, CDs, and bonds. Such assets can be taken into account when FmHA settles debt, but not in write-off or write-down. The result is that large amounts of debt are being forgiven under the Agricultural Credit Act of 1987 even though the borrower is fully capable of repaying by disposing of other assets. Borrowers with the largest write-offs are those most likely to have substantial amounts of other assets.

Awareness in a local community that a borrower has managed to preserve other assets while obtaining generous write-down or write-off of debt stirs resentments and discredits the agency and the program.

Recommendation:

Include all assets of a borrower in performing calculations for restructuring with write-down or net recovery buy-out.

10. Inventory Property

Issue:

How should inventory property be valued for sale to purchasers exercising buy-back rights? Should the county committee use random selection for multiple qualified borrowers?

Background:

Current law requires that inventory property be sold "at a price that reflects the average annual income that may be reasonably anticipated to be generated from farming such land." The same law also requires that land be offered "at a price not greater than that which reflects the appraised market value of such land." Because of this language, FmHA offers inventory property at capitalization value to purchasers exercising buy-back rights under the Act. Ordinarily, this should not be a problem when dealing with farmland because capitalization value should be consistent with market value as determined by comparable sales. However, sharp disparities arise when the property could be used for more intensive, non-agricultural purposes. Capitalization value, which is restricted to agricultural use, thus may well fail to reflect true market value, costing dollars to the government.

The other problem with the law stems from the requirement that the county committee, in disposing of inventory property, select from among qualified applicants the one who has the greatest need for farm income and best meets the criteria for eligibility to receive loans. This puts a great burden on the county committee, requires difficult and subjective judgments, generates multiple appeals by disappointed would-be purchasers and delays sale of such property.

Recommendations:

Change "capitalization value" to "appraised market value" where needed. Allow the county committee to use random selection for cases of identical bids by multiple qualified bidders.

11. Time Extensions

Issue:

Whether the time limitations for debt restructuring are adequate.

Background:

Experience with administration of the Agricultural Credit Act of 1987 borrower rights provisions has demonstrated that the amount of time provided is unrealistically short in the case of borrowers who are given 45 days in which to prepare their requests for restructuring or to arrange for financing under net recovery buy-out. The 60 days now provided for FmHA to process a request for restructuring is similarly deficient, in that there is often insufficient time for the borrower to close out his production year and provide current crop-yield and sale-price data on which to base a realistic evaluation of the borrower's operation.

Recommendations:

Extend the time for a borrower to develop a restructuring request from 45 to 60 days. Extend the time for a borrower to arrange financing for net recovery buy-out from 45 to 90 days. Extend the time for FmHA to process restructuring requests from 60 to 90 days.

12. Secondary Market for Guaranteed Farmer Program Loans

Issue:

How to establish a secondary market for guaranteed Farmer Program Loans.

Background:

PL 100-233 required the Secretary to "develop such procedures as are necessary for the facilitation, administration, and promotion of secondary market operations..." for guaranteed portions of FmHA Farmer Program loans. There would be benefits to farm borrowers if the FmHA secondary market were incorporated into the Farmer Mac structure. These benefits include:

a. more competitive interest rates for farmers as a result of lower development costs of the secondary market, greater efficiency due to higher volume and elimination of duplication, and better investor acceptance;

b. earlier implementation of the secondary market;

c. greater interest in guaranteed FmHA Farmer Program loans as a result of increased lender awareness; and

d. elimination of the concern that FmHA secondary market activities should be scored on budget.

Recommendation:

Amend the Farm Credit Act to allow Farmer Mac to pool FmHA loan guarantees, including operating loans, and to waive Farmer Mac underwriting standards for FmHA pools.

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C. Farmers Home Administration

1. Interest on Interest

Issue:
Should FmHA be allowed to charge interest on interest payments that are less than 90 days overdue?

Background:
The prohibition against charging interest on interest which is less than 90 days overdue creates administrative problems when loans are reamortized. Currently, this interest must be dealt with separately when a new payment schedule is developed. Removal of this prohibition would permit FmHA to capitalize all unpaid interest into the principal balance when loans are reamortized. This would greatly simplify the transaction.

Recommendation:
Eliminate statutory prohibition against charging interest on interest payments that are less than 90 days overdue.

2. Certification of Loan Eligibility

Issue:
How to streamline the loan approval process?

Background:
Existing law requires that FmHA county committees certify the eligibility of a farmer program loan applicant each time an application is made. This requires a separate determination for subsequent loans, even though the applicant has been recently certified as eligible. This causes undue delay in the processing of loan applications, particularly during the busiest and most critical times of the year.

Recommendation:
Permit county committees to certify eligibility for farm operating loans for periods of two years.

3. Disaster Loans to Entity Applicants

Issue:
Eliminating inconsistencies in eligibility standards for disaster emergency (EM) loans.

Background:
Existing law makes corporations, partnerships, and similar entity applicants whose owner-operators are related by blood or marriage eligible for farm ownership and farm operating loans. It limits EM loans to only family-sized farming operations. This inconsistency means that certain entities cannot obtain an emergency loan, even though the members would be eligible for far greater amounts of loan funds if they applied as individuals.

Recommendation:
Extend eligibility for EM loans to entities whose members are related by blood or marriage, provided they meet other eligibility requirements.

4. Debt Settlement

Issue:
Should FmHA's debt settlement authority be consolidated?

Background:
The Consolidated Farm and Rural Development Act (CONACT), as amended by the Food Security Act of 1985, provides extensive debt settlement authority to FmHA. The 1985 amendments, however, removed the authority to act on debt settlements and release of liability arising from transactions under authority other than the CONACT. This category includes Economic Opportunity loans, Non-Program loans, Intermediary Relending Program loans, Nonprofit National Corporation loans, and claims against third party converters. The only authorities presently available to settle debt for these kinds of loans are the Federal Claims Collection Act and its implementing regulations, and general claims collection statutes. It would be more efficient from an administrative standpoint to consolidate such authority in the CONACT.

Recommendation:
Consolidate all FmHA debt settlement authority in the CONACT.

5. Limited Resource Interest Rates

Issue:
Should limited resource interest rates for direct FO and OL loans be consistent?

Background:
Under existing law, interest rates for limited resource borrowers are calculated differently for farm ownership (FO) and farm operating (OL) loans.

For FO loans, the regular (non-limited resource) interest rates may not exceed the current average market yield on outstanding U.S. marketable obligations of comparable maturities (25 years), plus 1 percent. The current Treasury rate for 25-year obligations is 8.125 percent. The FmHA rate is 8.75 percent. FO limited resource rates cannot be more than one-half of the current average market yield or less than 5 percent. The current FO limited resource rate is 5.0 percent.

For OL loans, the regular (non-limited resource) interest rates cannot exceed the current average market yields of comparable maturities (5-year), plus 1 percent. The current Treasury 5-year rate is the same as the 25-year rate of 8.125 percent. The FmHA rate is 8.5 percent. The OL limited resource rate cannot be more than the FmHA rate for regular OL loans, less 3 percent. Currently, the OL limited resource rate is 5.5 percent.

Recommendation:
Standardize limited resource interest rates for both farm ownership loans and farm operating loans, imposing a uniform rate of one-half the Treasury rate plus 1 percent, but not less than 5 percent. Under this formula, the current farm ownership loan and farm operating loan limited resource rate would be 5 percent.

6. Community and Business Program (C&BP) Application Process

Issue:
Should FmHA be allowed to hold C&PB applications until funds are available?

Background:
The 60-day limit for approval of loan applicants is having the unintended effect of forcing the disapproval of completed applications for loans and guarantees when there are not funds available to be obligated. When sufficient funds are not available, FmHA's only option is to decline the application. FmHA would prefer to hold an application that can be funded when funds become available rather than disapprove the application.

Recommendation:
Permit FmHA to accept and hold eligible applications until funds are made available.

7. Release of Liability for Community and Business Program (C&BP) Loans

Issue:
Whether FmHA county committees should certify release of liability for C&BP loans.

Background:
Current law requires county committee certification before approval of a release of liability for C&BP loans. The county committee is not involved in the making or servicing of C&BP loans except for these actions. The committee usually has no prior knowledge of the borrower and rarely denies these requests. The requirement does not appear to serve any useful purpose and impedes the processing of such releases.

Recommendation:
Eliminate county committee certification before approval of a release of liability for C&BP loans.

8. A-95 Review

Issue:
Should language referring to a cancelled OMB circular be removed from CONACT?

Background:
On July 14, 1982, the President signed Executive Order 12372,

"Intergovernmental Review of Federal Programs." The Order directed the revocation of OMB Circular A-95 and provided a new system of intergovernmental consultation. Under the Order, State and Federal Governments determine what Federal programs and activities to review and the procedures by which the review will take place. While the A-95 review process is no longer active, language referring to this process has not been eliminated from the CONACT.

Recommendation:
Eliminate language in CONACT referring to circular A-95.

9. Leaseback/Buyback of Non-Farm Collateral

Issue:
Reduce FmHA losses by limiting borrower's priority rights to regain possession of non-farm collateral under the leaseback/buyback program.

Background:
On rare occasions, FmHA is given a lien on non-farm property, usually as additional security for a farm program loan. Under current law, FmHA must offer to lease this non-farm property, as well as any farm property, back to a defaulting borrower under the leaseback/buyback program. The purpose of leaseback/buyback, which allows defaulting borrowers another chance to conduct a successful farming operation, does not require that the borrower be given a priority right to regain possession of non-farm property. The agency could reduce its losses by selling such collateral at the market price.

Recommendation:
Limit leaseback/buyback program to farm property only.

10. Disaster Loan Collateral Appraisals

Issue:
Whether the CONACT should require duplicate appraisals for disaster (EM) loans.

Background:
Farm assets depreciated in value very rapidly in the early 1980s. The CONACT was amended to require FmHA to use farm asset values from

a year prior to the date a disaster declaration designation was requested, unless present values were higher. This required FmHA to document EM loans as secured when, in fact, they were not. That situation has been reversed during the past 2-3 years, when asset values have increased. The current situation is such that present market values of farm assets, in virtually all parts of the country, are higher than they were a year earlier. Under these conditions, there is no need for the two appraisal approach.

Recommendation:
Eliminate prior year appraisal from the EM application process.

Senator CONRAD. Very well. Thank you, Sox, for that testimony, and Jack is certainly welcome. It's good to have you here as well. As you know, I will try to be informal here, and the goal is to try to understand and help our colleagues and the public to understand where we are, what the status of our programs are, and what the problems are, and what the possible range of solutions are. Then we try to make judgments on what it is that can be done, and what the tradeoffs are. So that is the spirit within which we will operate this hearing.

Sox, if we could go to page 2 of your testimony,[2] I would just like to start by trying to understand some discrepancies between what I see in the GAO report and your testimony. These may be timing differences in terms of numbers, but I just want to understand. You talked about the accumulated deficit at Farmers Home of $42.6 billion. Would this be the ACIF for the history of FmHA? That would be the accumulated deficit for the years the program has been in operation?

Mr. JOHNSON. No, sir. The $42 billion is not that. Of the $42 billion roughly that is for all of our programs.

Senator CONRAD. That amount is for all programs.

Mr. JOHNSON. And that actually is determined, as I understand the GAO report, and we have reviewed some of this with them and we have no problems in accepting the numbers once we understand what the numbers are.

Senator CONRAD. Right. That is what I am seeking to understand.

Mr. JOHNSON. What there has been, as I understand it, Mr. Chairman, there has been an accumulation of losses in the amount of $72 billion since we started with all of our programs for the 50-odd years—OK—for the history of this agency. This has been reimbursed through appropriations in the amount of about $30 billion. So 30 from the 72 gives you $42 billion over the life of the it; OK?

Senator CONRAD. All right. All right. So when the GAO says on page 6 [see p. 64] of John Harman's prepared testimony: "A significant portion of the nearly $40 billion in cumulative net losses for ACIF was recognized by FmHA during fiscal years 1987 and 1988", we are talking about two different things here? That would be one portion of the $72 billion that you are referring to?

Mr. JOHNSON. That is correct. The numbers that I have before me, and without getting this too complicated—anytime we can get into numbers, it can get confusing fairly quickly. But of that $42 billion, roughly $28 billion of that is actually the ACIF portion of the $42 billion if you are coming. Of that also, and the $42 billion, in a table that I have, and Mr. Chairman, once we conclude, I will be happy to give you my notes here if that might be helpful to you on a number of these numbers that I get confused on as I try to read the papers and other things. But maybe you will find it helpful. $27 billion of that is actually a provision for future write-offs. It is not actually a reserve that we set aside. It is not funded because, as you know, we come in for appropriations 2 years after we incur losses and so forth at the time. So this is an anticipation based on the value, as I understand it, of what we think our portfolio is now so with a potential over the life of those loans and everything, we have, in effect, included in there a $27 billion cumulative provision for future write-offs.

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[2] See page 6 for the testimony of Neal Sox Johnson.

Senator CONRAD. Over what period would that be?

Mr. JOHNSON. As I understand that would be, maybe we are going to have to get in more detail when you get your GAO guys here. But it is open-ended really. I guess that is saying that if we—and I certainly stand to be corrected on this—but if we were to shut down today and continue and had somebody to collect all they could from us, by the time we concluded, all the agreements and outstanding agreements we have, we would anticipate we would probably wind up with $27 billion to clean our books up.

Senator CONRAD. Do we have a breakdown of that?

Mr. JOHNSON. I will stand corrected on that though.

Senator CONRAD. Yes, well, we will have a chance to ask our GAO friends that question. Do we have a breakdown of that estimate, what types of loans? Did most of this come from those emergency loan programs?

Mr. JOHNSON. Certainly most of this would come. That is where we have suffered most of our losses. The $42 billion, let us see, accumulated losses include about $35 billion in interest subsidies. So that is just the subsidies that we applied to the program. $11 billion for write-offs of principal.

Senator CONRAD. Let me just make a suggestion in terms of language. I do not know if it is appropriate to use the word "losses" in referring to the interest rate subsidies because those were explicit subsidies provided by the Federal Government. I mean it was a program. It would be as if we referred to the defense budget as a loss. I mean it was an explicit program of the Federal Government. So of the $72 billion, $35 billion are part of the explicit interest rate subsidies that were provided through the FmHA program.

Mr. JOHNSON. That is correct.

Senator CONRAD. OK.

Mr. JOHNSON. And $11 billion write-offs of principal, and then the $27 billion that I mentioned earlier is the balance of it. That is our provision for future losses.

Senator CONRAD. For the future losses. Do we have a breakdown, Sox, of that $27 billion? What was causing or what has happened to cause that future anticipated loss? In what programs? Is it losses that we have seen from before, mostly those old emergency loan programs, disaster emergency loan programs? Do we have a breakdown of it?

Mr. JOHNSON. It is the high level of delinquency. I am looking here at the amount. We had a change from the 1987 cumulative when we got all the publicity and talked about a $36 billion loss. Now we are coming back with $42 billion. So we have a change in 1988 of $6 billion. So that is what got that future provisions up. We increased that from 21 to 6, and that got us up to the $27 billion.

Senator CONRAD. But do you understand? My question is in what programs are those losses anticipated to occur? Are they the result of programs that have already been terminated or sharply curtailed?

Mr. JOHNSON. That is correct. It is principally the emergency programs.

Senator CONRAD. Emergency programs. I just think for the purposes of all of our understanding, it is very important for us to know that in 1984, one of those programs was eliminated. Then the 1985 act sharply curtailed the others. So the underlying cause of much of what I would call our real losses are things that we have shut off. That is not to say we do not have some other problems because clearly we do. But in terms of what is driving these numbers, they are basically coming from the Emergency Loan Programs and the Disaster Emergency Programs, which were eliminated or sharply curtailed in the mid-1980's, and yet we are living with the results of those programs today, the results of the very loose lending criteria that applied to those programs.

Mr. JOHNSON. That is correct, and it is going to take us a few more years to work out of it, but those are the ones, and certainly the Agricultural Credit Act of 1987 cannot be said it is responsible for those losses.

Senator CONRAD. Right.

Mr. JOHNSON. I agree with your earlier statement there. The Agricultural Credit Act of 1987 gave us a window and some tools in which we could deal with those that have been distressed for many of those 10 years or so, certainly over the past decade, and obviously once we work through it, and I would expect it is going to take us another 2 or 3 years because still many of those, the stressed borrowers that we are working with are obviously still in bankruptcy. Some of them in appeal, mediation, and various status which we still have them, and we still have that delinquency on our books. At some point we will probably write those things off, and we will get this in balance.

Of course, one of our other hopes, and one of our great provisions, I think, of this, we hope that we do not get back in that shape again. So we hope that we will never get caught with the situation of extending credit and extending debt to borrowers that is going to be beyond their capacity to pay that debt, and we have done that——

Senator CONRAD. Yes.

Mr. JOHNSON [continuing]. With our policy in recent years continuing loans, continuation of loan policies and other things. But that is something we were all involved in, and I say it is all of us who are responsible for the situation. We have the tools and opportunity now to correct that. Let us hope that we do not reach too deep in trying to keep every farmer on the farm simply because they want to farm. We want to keep those that have the prospect of succeeding.

Senator CONRAD. All right. Let me ask you this question, and I hesitate to do this because it is another number. But——kLaughter.]

You also indicate on page 2 of your prepared testimony "according to the General Accounting Office, including losses of $13.8 billion in fiscal year 1988 alone." Now when I look at the GAO testimony, again on page 6 [see p. 64], they reflect losses, a net of $10.6 billion in 1987 and $2.9 billion in 1988. I am having difficulty understanding what the $13.8 billion relates to. Maybe you could help me with that.

Mr. **Johnson**. I tell you, Mr. Chairman, but this again is some of these papers I am going to be happy to leave with you when I get through. I have my staff trying to sort some of this out for me. As I understand it, the $13.8 billion operating loss incurred during fiscal year 1988 was attributed $6.4 billion to interest subsidy expense. So that gets back to that interest subsidy again.

Senator **Conrad**. OK.

Mr. **Johnson**. Six billion is an increase in allowance for losses. So that is that contingency. $1.1 billion is discount on loans sold, and then there was——

Senator **Conrad**. Excuse me. What is that number?

Mr. **Johnson**. Discount on loans sold. Somebody reminded me. OK. And this $13.8 billion relates to all of our programs now again so it is not just farm programs.

Senator **Conrad**. Let me just say to you, and for the purposes of the public and those who are listening in. This is why the use of language is terribly important to us, and if we are not very careful about the use of language, we will create terrible problems for all of us. When we say there is $13.8 billion of losses in 1988, some people will say, well, Sox, how can it be when you got $23 billion of loans outstanding, and you lose $13.8 billion in one year. How can that possibly be? I think what is important for us to communicate that we are talking about multi-year experiences being recognized in a specific year, many of which flow from programs that have been terminated. Again, that is not to say we do not have ongoing problems that have to be dealt with. But in order for people to put this in the right context—correct me if I am wrong—the $6 billion increase in expense for allowances would be a recognition of multiple year losses from previous years. It would not be a loss that occurred in 1988 specifically.

Mr. **Johnson**. That is correct. That relates back to that 27 figure.

Senator **Conrad**. Right.

Mr. **Johnson**. We are only talking about three things is the way I am understanding. Again, I stand corrected. When we refer to these losses, we are talking about the difference in what we have expended and what we have received back through appropriations. So we are talking about that which that takes in the three factors. That takes in any subsidies which some people could equate to a grant, but subsidies, interest subsidies. It takes in the actual losses that we normally think of losses because somebody did not pay their bill, or we suffered a loss from that standpoint. And then it takes into consideration the projection, setting aside because of completing your agreements with these people of the anticipated losses on those in the future.

Senator **Conrad**. Yes. And again, let me indicate that the $6.4 billion that is interest subsidy, I would not describe that in common parlance as a loss. That is a program expense just as you would have in any of the programs of the Federal Government, an expenditure. There is an expenditure made to provide a reduced interest rate, but it is not a loss in the sense that you ever anticipated getting that amount repaid.

I think when we are communicating with the public, if we are not careful with the use of language, people will wonder how can a problem that has only $23 billion in loans outstanding lose $13.8 billion in a year. It is because we are mixing our language here.

Let me go to page 3 [3] of your testimony with respect to guaranteed loans. You are advocating more movement to guaranteed loans. I would like to draw your attention to page 20 of the GAO testimony in which it says:

> In addition, shifting funding from direct to guaranteed farm loans will not solve FmHA's problems. With the increased credit costs and the greater risk of liquidation associated with guaranteed loans coupled with direct loan borrowers' poor financial conditions, it is unlikely that significant numbers of direct loan borrowers will shift to guaranteed loans in the future. If direct loan funding continues to decline and delinquent direct loan borrowers continue to request direct loan financing * * * funding may not be sufficient to meet future credit needs of all direct loan borrowers.

And I would also refer you to earlier in the GAO prepared testimony on page 15 in the first full paragraph there, the last sentence:

> Consequently, despite the progress in shifting from direct to guaranteed lending, the Government's overall financial exposure has increased.

Continuing in the next paragraph:

> While FmHA's guaranteed farm operating and ownership loan activity has significantly increased since 1984, losses on these loans have grown at a faster rate. Loan delinquencies are also growing, and FmHA projects that losses on guaranteed loans will increase in the future.

Let me say to you if we look at the numbers on the guaranteed loans, you have obligated nearly all the direct loan funds annually, but are using only about 35 percent of the guaranteed loan allocations. This shift in funding that I had previously referred to has resulted in a 65 percent drop in operating loans made by FmHA and a 59 percent drop in Farm Ownership loans.

In 1989, FmHA received three times the number of applications for direct loans as for guaranteed loans. My question to you would be this: Given this data, how do we expect Congress to agree to slash direct loans by more than 50 percent as proposed in the President's 1991 budget?

Mr. JOHNSON. OK, Mr. Chairman. The guaranteed lending program certainly in our start up period, we essentially did not have a program back until 1984, and then we started off then with a program. We feel that we have made some significant gains in that in a number of ways. Certainly I think we all recognize if we can have an effective guaranteed program from a budgetary consideration that is much more favorable than having direct lending to make use of the private sector funds.

Senator CONRAD. Could I stop you right there, and just say for the purposes of the audience, they probably do not understand the reason for that statement. I think we should just make clear in the record that when you make a direct loan, the way the budget of the Federal Government works, that loan is scored as an expenditure at the time you make it. If you make a guaranteed loan, it does not count at the time you make it. Any losses are recognized on the budget at a later point when, and if in fact, the guaranteed loan was in default, and the Government would pay on the guarantee, that is the underlying reason for the statement just so the news media and others understand. Go ahead.

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[3] See pp. 7 to 8 for testimony of Neal Sox Johnson.

Mr. JOHNSON. So certainly we have had some start-up. We have not had the degree of shift from direct lending as the report properly points out that we would have liked—direct loan borrowers to the guaranteed lending. Most of the guaranteed lending we have done has gone to new borrowers coming from other lenders, farmers that were going to have to go out of business because those lenders were going to cut them off without some assistance.

So we think we played an important role there. We do feel, however, that as time goes on and as we have learned a lot with our program, and particularly one as is proposed by the administration's farm bill proposal, and I do note that it is a proposal—not just a farm bill position but a proposal—we have provided enhancement that we think would be helpful to the farmers with a guaranteed loan is this buydown. We feel in order to meet the targeted group that we are expected to take those beginning farmers, those people that need our assistance until such time as they become successful to the point and can convert to private sector lending. We feel that we cannot do that at the traditional rates charged by most lenders with many of these.

So that is the reason that we are providing, and the administration is suggesting in this proposal, that we do have an additional buydown to help. So we think that we are on the verge of having a program that will not only address the farmers that are coming to us from other private sector lenders with our guaranteed program, but we are in position. We feel that we have about 9,000 commercially rated borrowers on our rolls. And we have educational things to do with our employees and others, but we also have about 40,000 that are standard, and with these buydowns that many of them that in time we can convert to private sector lending with a guarantee from us.

So we see a potential of some of our direct loan borrowers working out. We simply have not had time to work the guaranteed program the way we would like because we have all been almost obsessed, as I have said here before, in working with this 60 or 80,000 distressed farm borrowers we have. We have devoted most of our resources to that when we unfortunately had to let some of our others that were being successful and working, the other 150,000 or so, we have not been able to give the attention and supervision and in trying to work with them and connect them with the lender so they can make that shift. We believe it will happen.

Senator CONRAD. Well, let me follow up and ask you this. Your proposal that you have just talked about would expand the current interest rate reduction program. In 1988, FmHA obligated only about 10 percent of the allocation for that interest rate reduction program. GAO finds that the lack of interest in the program is due to the fact that lenders are unwilling to take on the high risk of financial failure of borrowers unable to project a positive cash-flow without the interest rate reduction loan. What makes you believe that this new proposal which would allow FmHA to pay the entire cost of reducing private interest rates will significantly increase use of the guaranteed program?

Mr. JOHNSON. Because we are not, the lender is not having to cut the rate. We are going the full up to a maximum of 4 percent. We think it will average out probably about 3 percent discount, but we think there is going to be a lot more interest on the part of the bankers. The type that we found, at least that came to my personal attention from lenders and others as we were working particularly through the last crop-year, that was kind of a last resort. It was easier for the lenders at that time, if it was kind of a higher risk to go ahead and shift them back to Farmers Home direct loan. OK. But if we had ample funds, that is what probably would have happened to a lot of those, but with the constraints, and that is the reason we are having to gauge down and reduce the number of available direct operating funds as we increase guarantee. We have to maintain the balance to serve those farmers. We recognize that, both existing and the new we want to handle. But it is important that we do get that balance and make that shift.

So what we found many of those when we saw that we were running short in a locality of direct operating loans, those bankers, if they were really interested in that borrower and the welfare of their community and so forth, many of those bankers would come in, and we would explain and have to talk to them more about the buydown, two to two, and many of those in order to cash-flow only had to cut a quarter of a percent or something like that. They did not have to go the full 2 percent now because all they had to do was get to the cash-flow level. So they found it worked, but we found the bankers were a little more selective. If operating funds are going at 12 percent, and we are saying, hey, if needed to cash-flow, we will subsidize 4 percent of that and get that down to an 8 percent interest rate. We feel that there is going to be a lot more bankers interested and promote this and use it and a lot more interested as well as we think that our people and the farmers can come closer.

Senator CONRAD. Let me ask you this. There is another vote on, and I am going to have to leave momentarily. In fact, I better leave now, and I will come back and address this issue. The question I am going to ask you when I get back is have you talked to private lenders? Have you surveyed them in a way that would give us some evidence that they are going to be willing to loan to these people given what the GAO has indicated about their unwillingness to loan to such borrowers because of the risk of these loans? That will be the question. You have a chance to think that over. The subcommittee will stand in recess.

[Recess.]

Senator CONRAD. Well, my apologies. Sox, I asked a question before I left and perhaps you have had time to think of your response. Why do we not take this opportunity to hear that and then we will move on.

Mr. JOHNSON. All right. You may want to repeat your question again, but I think I have the gist of it. If not, we will—what are we doing to, or why are we so positive that a guaranteed loan program will work? I think that was basically your question. We find there is a lot of interest. Obviously we have been working regularly and diligently with IBA, ABA bankers, Farm Credit System. We have been trying to talk with all of these because we are interested in farm lending out there and generating more. And I think that is a goal and objective you have. How can we make it work?

We find that some of the greatest deterrence that we have to it is just general misunderstanding of our program and our commitment, and assurance we are going to pay off on guarantees if they are legitimate and due at the end, as well as the paperwork. How can we reduce and how can we—you know—we talk about a docket, and most bankers say what is a docket, you know. And to them it may be a case file or something else. So we have a lot of just little problems like that. We have devoted, particularly in the past year, a lot of time with those lenders. We found great interest. Jack and I just a week ago last Saturday met with the ag executive board of the American Bankers Association. I got very positive vibes from the 40 or 50 or so present at that meeting that they were very much interested in participating and working with us. So we have homework.

I feel that there has been some good positive groundwork laid in the last 4 years. What we need is certainly we have to make, if we are going to get these borrowers that are more marginal borrowers of the type we need to be dealing with, there has to be those interest rate buydown and some of these concessions to give the incentive to the lenders. But we have simply got to get out there and work with them and see if we cannot get this going. The vibes that I am getting back are positive. Now obviously, I have not had any direct discussions with what is in the proposal, the farm bill proposal, here with any. But I am expecting it to be positive because we have laid a lot of groundwork indirectly, and obviously some of our thinking is reflected in this farm bill proposal. So hopefully I have answered your question. I may have rambled and talked about more stuff than you wanted me to talk about. I do not know.

Senator CONRAD. That is all right. According to the GAO report,[4] some 42 percent of borrowers have had loans with FmHA for over 7 years. Clearly, the graduation principle is not working here, and GAO cites as one significant reason the fact that their financial condition does not qualify them for private credit. Your proposal would end eligibility for FmHA direct loans after 7 years, and after 10 years for direct and guaranteed loans combined. If these borrowers do not qualify for private credit at the end of that period, what would happen to them?

Mr. JOHNSON. They would be out after they completed the stint. There is one thing—I think it is only fair to borrowers and to our employees and all with the attitude, if we are going to be serious about a graduation program, people have to know what their goals and objectives are. And we are saying 7 years because by the same numbers you cited there, you see a big percentage of those borrowers are out of the program within the 7 years. OK. So we think that a lot of those that are not is a lot of this carryover of some of those very marginal stressed farmers over the last some years. So that is where we would see a lot of those. We feel that if everybody knows going in, a farmer knows, the County Supervisor knows, the lenders know, and we are going in, and we are going to be with them 7 years, we feel that that will be an objective.

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[4] Farmers Home Administration: Farm Loan Programs Have Become a Continuous Source of Subsidized Credit (GAO/RCED-89-3; Nov. 22, 1988).

We think that our people will devote the time needed and their goal will be to see that that person is ready to move out of our program within 7 years. I believe we can accomplish that. I think it is realistic, realistic time frames.

Senator CONRAD. Let me ask you this. If the appropriate role of FmHA is lender of last resort, and if these people can meet their repayment schedule but cannot find credit elsewhere, should we not be saying to those people you are out of farming? I mean just as a principle? Does that make sense?

Mr. JOHNSON. What we are saying we should only be dealing with those that have a reasonable prospect of success. They should not look upon us as lifetime farmers. We have some of those borrowers, I know some that have been with our program for 20 years or so. Some of them may be rated by our rating system as commercially rated and could convert now, but between the attitude of that farmer, hell, they do not want to change. They are going to stick with Farmers Home if the program is available to them. So they do not have any motivation. The motivation is to just stick with us as many years as they can.

And our County Supervisors certainly do not like to get rid of their better farmers. They have been working along and things are going pretty well so why should they graduate? We are determined to put some credibility to the graduation because we think that was expected of our program, and we put it in the elements and standards, if you will, on performance rating of all of our County Supervisors, district directors, program chiefs, state directors, and right on up the line.

We are letting them know we are serious about this because we do not want you dragging your feet. We want you to give that person the intensive servicing they need so they can be assured of succeeding and be prepared to grow out of that and not just wait for a borrower to go out and find a bank. Farmers Home will guide you to go out there and help find that bank. You work with all these other lenders to the extent you know what the lending policies are of all of those. And you help prepare the necessary paperwork. If we need to do a guarantee to make that transition, that is the reason we put the 10 year combination. They can be with us, say, 7 years direct, 3 years guaranteed, but by that time, if they are going to be successful they should be within that period of time.

Senator CONRAD. But, Sox, let me ask you again. If we face up to hard reality, we are at the end of the period, whether it is the 7 year period or the 10 year period, and we have a farmer who is making his payments, but cannot get commercial credit. Are you going to say to that farmer you are out of farming?

Mr. JOHNSON. Keep in mind we monitor these things, and I hope we will even do a better job through improved automation systems that we are trying to get in place and are getting in place and all those kinds of things. But we are monitoring. You and your committees and other committees of the Congress are monitoring as well as, you know, the Administration and Office of Management and Budget. We are all looking at this situation. Obviously, I am expecting us to make some dramatic turns if we get these tools. We have to let our employees know that we are serious about graduating these borrowers and we want them to give the attention and supervision necessary to graduate, and we have to let the farmer know that he has got to go. And he has to start working toward that goal and not just rely on Farmers Home always being there to take him.

So we have to set some times. Certainly as we go down the line we are going to be monitoring this. We are not going to wait for 7 or 10 years out here and then say, OK, you folks are going out. You are going to be seeing as we approach it, obviously if we have not been successful and if we have not been back and returned as we are proposing, and got back to our basic mission of supervised credit and started turning this thing around, then obviously I would expect Congress to take some other actions that was appropriate at that time to take care of those things if there was a need to extend or whatever.

Senator CONRAD. Well, let me——

Mr. JOHNSON. But I would hope, we really believe that the system will work.

Senator CONRAD. But let me ask you the question again because I think the question needs to be answered. If we followed your recommendation and we passed a law that said at the end of 7 years, and I gave you the hypothetical question of a farmer who can make his payments but cannot get commercial credit, are you suggesting as policy of the Government that we would say to the farmer, one who was able to pay his loans, you are finished farming?

Mr. JOHNSON. If that farmer cannot with Farmers Home's assistance in working with him get, be able to find credit that he can afford, we have not succeeded with him because you are still talking about a very marginal operation that has not made progress within that 7- or 10-year period. And, you know, to answer your question simply, yes, he would be out as a matter of policy, and that is what we are advocating. And I believe that that is the only way we are going to set it and get the effective program and get the attention of both our employees and the farmers to know what their goal is.

Senator CONRAD. Let me ask you this, Sox. What does it mean to you that FmHA be a lender of last resort then?

Mr. JOHNSON. That means that the operation, the farming operation, cannot generate enough profit or income to pay conventional interest rates and so forth that is needed to carry the credit and that that, however, that farmer does generate a positive cash-flow and has a prospect for succeeding in that manner, but at that time is just not ready to go for conventional financing. That is the niche that we think we see. If they can get credit from the lenders, other lenders, credit sources, then, credit elsewhere, we should not be making because that other lender is saying these people in their judgment can pay their debt service and so forth, and therefore, they would extend it. So that is the credit elsewhere provision to me.

Senator CONRAD. Yes.

Mr. JOHNSON. We are looking at a different niche from the commercial lenders because we are saying we want to take those beginning farmers, those that do not have the experience, because many of these it is not just a matter of the income. They have not had the experience and so forth, particularly beginning farmers, for commercial lenders to take. So we are looking at that niche that we think has the prospect of going on to commercial credit, and we are going to try to help them by supervision and coordination, and we are going to give them the early chance. So we are taking a higher risk than we would expect a conventional commercial lending source to do.

Senator CONRAD. Let me just say to you that in listening to your answers, I would say there is a dramatic change in what FmHA, a lender of last resort, would be under this formulation. I must say to you it would trouble me greatly if the Government were to set as a policy in this country that if you are not able to get commercial credit, even if you have been a good FmHA borrower, made all of your payments, but for whatever reason at the end of the 7 years, you could not get commercial credit, that we would say to that farmer you are done, you are finished.

That would trouble me. I think it makes great sense for FmHA not to be having as customers people who could be in the commercial sector, and it makes great sense for us to promote graduation. It makes great sense for us to tighten the kinds of lending that we do so that we do not have loose lending policies. I think all of that makes good sense, but I will say to you that if we are saying that at the end of 7 years, if you cannot get commercial credit you are done, even though you have been making your payments, that is a new policy that I could not support. I do not know if you would be able to look a farmer in the eye, and say this, when for example, in my State, you look at the last 7 years. We have had commodity prices collapse. We are in the third year of drought. If you had a guy that was making his payments on FmHA, and you say, well, it is the end of the 7 years. You cannot get commercial credit, pack up your family and head for the hills. Could you do that?

Mr. JOHNSON. I cannot conceive that there would not be a commercial lending source, a banker, Farm Credit or something that would not be willing to take on a borrower, particularly with our guarantee after 7 years, that had a track record—experience of 7 years of operation and had been able to pay his debts, as you describe. I cannot conceive that our lending institutions would not take on such a borrower. So I am not saying that with such a policy there may not be a few people drop through the cracks. I understand that. I do not see our policies as setting forth something that is going to be 100 percent coverage for everybody. But I still believe by far the majority and basically all of them—you know, in my experience I just cannot conceive that we could not find a lender, if Farmers Home has done their role and working with that person and that person has paid their debts and they have a track record and been successful for 7 years.

I cannot conceive that there is not a lender that we cannot find to take them on with at least a guarantee that we may have to put on there to get them in the door and then give them that 3 more years there and at the end of 10 years, you know, they are not making progress. If not, well maybe somebody has done a favor by not helping them and not keeping them on there. But I do not believe that is going to be a major problem in the operation of the program. I just cannot conceive of it.

Senator CONRAD. All right. Well, we may have a difference.

Mr. JOHNSON. And I certainly do not want to hope that we are not interpreting the credit elsewhere test to suggest that we should be dealing with people that cannot afford to make their payments and act in good faith and all those things. I hope we are not, because if we do, we are going to get back in the same deal that we have been in before, and you know we are going to have to rehash some of these big numbers again. And let us hope we can certainly avoid that, and that is what I hope we are all wanting to do.

What I see our proposal doing, I do not see it being a real drastic change. I believe I see it making a subtle change, but to really emphasize some key points that we are not going to be a lifetime source of credit for farmers, but that we do want something to help take that risk and for us to take on our role as that supervised credit and get back in that and get them ready for the conventional credit sources.

Senator CONRAD. First let me comment that I see it as a more dramatic shift than you do. If we are saying to folks, FmHA, which is the lender of last resort, is actually not going to be a lender of last resort, and even if you have been a good customer, if you come to the end of the 7 years and cannot get commercial credit, you are out of farming, then that is a radical change and I think that will meet with great resistance.

The testimony you have given here indicates the intention to increase the supervision of credit substantially. In other words, you propose to return FmHA to what was the original purpose of supervised credit. However, I do not see anything in your farm bill proposal that would improve the ability of County Supervisors to assess loans and assist borrowers in gaining the kind of financial management skills that would be necessary to really provide assistance. Can you tell me what kind of background is required to qualify as a County Supervisor?

Mr. JOHNSON. A County Supervisor must have, well, right now in our classification at least 30 hours of agricultural training. We would like to see that and are hoping to change that to require more financial backing. So we are looking at that. So we do have, obviously, the educational requirements. We like to look at somebody that is certainly familiar with agriculture because we have a requirement that all of these be classified as what we call the 475 series agriculture so they have some agricultural training in there. So that is what we are looking at. I would hope that we would do a lot of other things that we have on the table that we are currently working with right now that as we get more time to devote to it.

We need a lot more specialization in this agency. We need a lot more separation of duties. We expect too much of a County Supervisor. He cannot do all of it. Hell, he could not even keep up with all the books that we provide him to read. So we must have more specializations, particularly in areas such as underwriting, and so that it is not one—if there is a personality clash, which, you know, we have talked about some of these in the past, someone else needs to be looking at it. We need to be making more objective decisions, and when a person in Farmers Home makes a decision on credit that is impacting on the life of a farmer, there should be someone else to look to be sure that we have made the best objective decision.

So I think there is a lot of training. There is a lot of specialization, so we have a lot of things we need to do. Obviously we have to do them very subtly within our organization, but we have a lot of things underway, and when we can free up our people's time from again being obsessed with what we have had to go in working through the process with the Agricultural Credit Act of 1987 and getting them working on these 150,000 or so farm borrowers that we have that are being successful out there, then we can give the type of supervision and training with additional specialization and training that we are looking to do.

Certainly we are looking to do a lot more as we move into the guaranteed lending and joint training and so forth with ABA and the banking and farm credit systems. We are looking to do a lot more things that are going to expedite a lot of our processes, speed up processing paperwork, simplify, standardize it. Those kinds of things, I think, will free our people's time up, more so. They can really work with those and help those borrowers start looking for those other sources of credit they are going to need at the end of their time with Farmers Home.

Senator CONRAD. Let me ask you two quick questions, things that I do not think you will be able to provide here today, but perhaps you could get for us.

One would be an analysis of those borrowers who have been with you for more than 7 years that are current, that are not judged commercially creditworthy. In other words, I want to try to understand how many people we are talking about here that under this new policy you would say, you have been a good borrower, but you cannot get commercial credit so you are out of farming?

A second question that I would have would be, in your analysis, how many borrowers currently receiving FmHA assistance would be eliminated from the FmHA system by the set of proposals that you have made here today? Please give us an analysis of how many borrowers in the various loan program categories would be eliminated from further involvement in FmHA according to these proposals.

I may have some other questions that I will submit for the record, but given the lateness of the hour I think we better move on. Anything else you would want to add, Sox?

Mr. JOHNSON. I will simply say on those two questions, those may require some work, but I think they are very good questions you are asking, and we will—it is probably going to even require a surveying of all of our individual county offices in order to try to get at the question, but we will make an effort at that, and hope to get that as quickly as possible for you.

[The requested information was subsequently supplied for the record and follows:]

NUMBER OF YEARS of FmHA FARMER PROGRAM ASSISTANCE

The following analysis was conducted to estimate the impact of proposed limits on the number of years borrowers may receive Farmers Home Administration operating loans.

The data are from two nation-wide samples of Farmer Program borrowers. The first set of data was collected in 1985, and the second was collected in 1988-89.

IMPORTANT LIMITATIONS OF THIS ANALYSIS:

1. The data only show the number of years since the borrowers received their first Farmer Program loan. For all but a small percent of the borrowers in the 1985 sample, there is no way of knowing how much longer they will receive FmHA assistance.

2. The data include all borrowers in the samples for whom the year of first Farmer Program loan is known. (This is almost all borrowers in 1985. In 1988, "first year" is missing for 17 percent of the cases.) Without the complete loan file, it is not possible to separate exclusively Operating Loan borrowers from those who have, or have had, other types of loans.

All we can say is that, at two different points in time, a very large percent of the borrowers in two different samples had been receiving Farmer Program assistance for no more than 14 years.

Analysis by Selected States

An Analysis was conducted to determine number of years of assistance on a state-by-state basis. For the 1988 data base this was limited to the fifteen states, listed in Table 1., that had at least 50 cases. In selecting the 1988 sample a proportionate number of borrowers was selected for each state. (This was also done for the 1985 sample.) Hence the 15 states have the largest Farmer Program case loads. The number of cases in the remaining states is too small to achieve reliable results on an invidual state basis.

The first column in Table 1. (1988 data) shows that, of all borrowers in the total sample, and in the 15 state subsample, slightly more than one-half received their first loan no more than seven years before 1988. Another 37 percent in the full sample, and 35 percent in the subsample, had been receiving Farmer Program assistance for 8 to 14 years, and would be within the one-time rescheduling limit. About 5 percent of the borrowers in each group had been in the program for 15 to 17 years, the proposed maximum for combined direct and guaranteed credit. Less than 5 percent of the borrowers had been receiving credit beyond all proposed limits.

Tennessee, Arkansas, Iowa, and Missouri have the largest proportion of shorter term borrowers. In each of those four states, at least two-thirds of the borrowers had been in Farmer Programs for no more than seven years. Oklahoma, Illinois and the Dakotas had the smallest percent of short term borrowers. Oklahoma also had the largest proportion of borrowers (12 percent) who had been receiving assistance for more than the proposed 14 year limit for direct Operating Loans, but who would still be eligible for guaranteed loans. North and South Dakota had the largest proportion of borrowers, 10 percent in each state, who had exceeded the proposed limit of combined direct and guaranteed assistance.

The same fifteen states included in the 1988 subsample were selected from the 1985 data base for a state-by-state analysis. The results are shown in Table 2.a. Of all borrowers in the total sample, and in the 15 state subsample, 63 percent had received their first Farmer Program loan within the previous seven years, and about one-fourth got their first loan within the 14 year direct loan time frame. About 5 percent had been in the program 15 to 17 years, and less than 8 percent had exceed the proposed limit of combined direct and guaranteed credit.

The results are very similar for a second subsample of borrowers in 11 states that had at least 50 cases in the 1985 data base but not in the 1988 data set. See Table 2.b.

The differences between the 1985 and 1988 samples in the percent of borrowers in the "New to 7 Years" and "8 to 14 Years" categories probably reflect the big influx of borrowers in the 1978-79 boom years for Emergency Loans (EM) and Economic Emergency loans (EE).

In 1985, Illinois, Iowa (Table 2.a.) and California (Table 2.b.) had the largest proportion of shorter term borrowers. At least 75 percent of the borrowers in those states had been in Farmer Programs for no more than seven years.

Mississippi, North Dakota, Oklahoma (Table 2.a.), South Carolina, and Virginia (Table 2.b.) had a substantially larger than average percent of borrowers who had exceeded the 14 year limit for direct loans, but still might have qualified for guaranteed assistance. In Mississippi, Tennessee, Wisconsin (Table 2.a.), Alabama, Georgia, and Idaho (Table 2.b.) more than 10 percent of the borrowers had passed the time limit for combined direct and guaranteed loans. Georgia had the highest proportion of borrowers (13.8 percent) in this category.

Analysis by Classification

The number of years of Farmer Program assistance was analyzed in relation to the borrower classifications for both the 1988 and 1985 total samples. It was not possible to do this type of analysis on a state-by-state basis.

The individual cell percentages in Tables 3. and 4. are based on the total cases in the sample, not the column totals. For example, there are 457 borrowers who are in the "New to 7" category and are classified Substandard. This is 27.4 percent of the total sample of 1,669 cases. The cell percentages do not total to 100 percent down the columns or across the rows.

Table 3. 1988 Data

BOXES A.1., A.2., and A.3. The Standard and Commercial Borrowers are the potential candidates for graduation, at least to guaranteed credit. A total of 13.4 percent of all borrowers are in one of these two classifications and in the New-to-7 Years group (Box A.1). Another 8.3 percent (Box A.2.) are classified Standard or Commercial and are in the 8-to-14 Year group.

About 1 percent (Box A.3.) are close to the maximum for combined direct loans with rescheduling, and guaranteed credit.

BOX B. A total of 58.4 percent of the borrowers are within the proposed time limits for direct assistance (including one-time rescheduling) but, being classified as Substandard or Doubtful, are not likely to be acceptable to other lenders even with guarantees, and therefor would not qualify for the additional three years of guaranteed credit.

BOX C. About 10 percent of the borrowers are also within the proposed 14-year limit for direct operating loans, but their accounts are classified as Loss. It is likely that assistance to these borrowers would be terminated by existing loan servicing authorities, or at the end of the 14-year limit for direct loans.

BOX D. That leaves 8.9 percent of the borrowers across all classifications who would have exhausted their eligibility for FmHA direct and guranteed operating credit. The 1.9 percent in the Standard/Commercial classifications could probably obtain credit from commercial lenders.

Table 4. 1985 data

The same type of analysis was done for the borrowers in the 1985 sample, with a few exceptions:

1. All of the borrowers in the Acquired/Liquidate column, (Box E.) 9.7 percent of the total, were already on their way out of the program in 1985. There are no "Acquired Assets" or "Liquidation" categories in the present classification system.

2. There is a larger percent of borrowers in the potential guaranteed loan group (Standard or Commercial) in 1985, and a smaller percent in the Vulnerable/Substandard group. Standard was the largest classification group in 1985. In 1988, Substandard was by far the largest group. This is probably due to the differences in the classification systems rather than a deterioration of borrower financial status.

The important similarity between the 1988 and 1985 data is the percent of borrowers who would exceed the proposed limits in years of operating assistance: about 9 percent in each sample. It is likely that more complete data would show that a large percent of the very long term borrowers have, or have had, real estate loans which typically have terms of 20 to 40 years. The state-by-state analysis for the states with the largest Farmer Program case loads indicated that the patterns of years of assistance do not differ significantly in the individual states.

The results of the analyses presented here are also consistent with the findings of a recent study conducted by GAO reported in Farmers Home Administration Farm Loan Programs Have Become a Continuous Source of Subsidized Credit (GAO/RCED-89-3, November, 1988). The categories for years of Farmer Program assistance used by GAO are slightly different than the categories used in the present analysis. GAO estimated that 57 percent of the borrowers had been in the program for less than seven years, and 78 percent had been receiving Farmer Program assistance for no more than 10 years.

Conclusions and Implications

The results of the FmHA studies and, the one conducted by GAO, suggest that only a small percent of FmHA Farmer Program borrowers would be subject to termination of FmHA credit if direct operating assistance was limited to a maximum of 14 years (initial loan plus a one-time rescheduling), and combined direct and guaranteed assistance was limited to 17 years.

The proposed limits on years of operating loan assistance could have several important impacts. First, if borrowers know that FmHA credit will be terminated within a specified time period they are likely to be more prudent in planning their credit needs. Second, for the more financially solvent, lower risk borrowers, there undoubtedly will be a higher rate of transition from direct to guaranteed loans, and ultimately to independent, commercial credit. Finally, specific limits on years of operating loans are likely to reduce unncessary costs to the Government, and drains on the resources of the highest risk borrowers.

The results of several previous studies conducted by FmHA show that a one-time adjustment in borrowers' debt servicing schedules can help them to successfully cope with temporary cash flow problems. Those studies also indicated however that repeated use of debt adjustment and loan restructuring, along with additional loans, typically keep borrowers with inadequate production and financial management skills and other resources in a downward spiral of insolvency.

Table 1.

YEARS OF FARMER PROGRAM ASSISTANCE

(1988 Data)

STATE	7 or Less		8 to 14		15 to 17		More than 17		Totals
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	
ARKANSAS	50	68.5%	19	26.0%	2	2.7%	2	2.7%	73
ILLINOIS	33	43.4%	35	46.1%	3	3.9%	5	6.6%	76
IOWA	67	66.3%	29	28.7%	1	1.0%	4	4.0%	101
KANSAS	38	61.3%	20	32.3%	2	3.2%	2	3.2%	62
KENTUCKY	30	51.7%	23	39.7%	5	8.6%	0	0.0%	58
MINNESOTA	32	52.5%	23	37.7%	4	6.6%	2	3.3%	61
MISSISSIPPI	33	57.9%	19	33.3%	1	1.8%	4	7.0%	57
MISSOURI	49	65.3%	20	26.7%	3	4.0%	3	4.0%	75
NEBRASKA	36	58.1%	21	33.9%	4	6.5%	1	1.6%	62
NORTH DAKOTA	28	46.7%	21	35.0%	5	8.3%	6	10.0%	60
OKLAHOMA	34	42.0%	35	43.2%	10	12.3%	2	2.5%	81
SOUTH DAKOTA	30	37.5%	38	47.5%	4	5.0%	8	10.0%	80
TENNESSEE	41	73.2%	14	25.0%	1	1.8%	0	0.0%	56
TEXAS	59	53.6%	42	38.2%	6	5.5%	3	2.7%	110
WISCONSIN	36	60.0%	18	30.0%	3	5.0%	3	5.0%	60
Totals	596	55.6%	377	35.2%	54	5.0%	45	4.2%	1,072
TOTAL SAMPLE	893	53.5%	612	36.7%	86	5.2%	78	4.7%	1,669

Table 2.a.

YEARS OF FARMER PROGRAM ASSISTANCE

(1985 Data)

STATE	7 or Less		8 to 14		15 to 17		More than 17		Totals
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	
ARKANSAS	126	68.5%	39	21.2%	8	4.3%	11	6.0%	184
ILLINOIS	114	75.5%	30	19.9%	3	2.0%	4	2.6%	151
IOWA	166	79.4%	27	12.9%	7	3.3%	9	4.3%	209
KANSAS	74	61.7%	32	26.7%	4	3.3%	10	8.3%	120
KENTUCKY	106	68.4%	27	17.4%	8	5.2%	14	9.0%	155
MINNESOTA	92	59.0%	53	34.0%	6	3.8%	5	3.2%	156
MISSISSIPPI	107	52.2%	58	28.3%	17	8.3%	23	11.2%	205
MISSOURI	117	62.9%	48	25.8%	10	5.4%	11	5.9%	186
NEBRASKA	100	63.7%	40	25.5%	1	0.6%	16	10.2%	157
NORTH DAKOTA	74	58.7%	33	26.2%	13	10.3%	6	4.8%	126
OKLAHOMA	105	67.7%	30	19.4%	13	8.4%	7	4.5%	155
SOUTH DAKOTA	91	47.4%	76	39.6%	7	3.6%	18	9.4%	192
TENNESSEE	84	61.8%	33	24.3%	2	1.5%	17	12.5%	136
TEXAS	145	60.2%	72	29.9%	10	4.1%	14	5.8%	241
WISCONSIN	62	53.4%	36	31.0%	5	4.3%	13	11.2%	116
Totals	1,563	62.8%	634	25.5%	114	4.6%	178	7.2%	2,499
TOTAL SAMPLE	2,617	63.4%	1,003	24.3%	188	4.6%	322	7.8%	4,130

Table 2.b.

YEARS OF FARMER PROGRAM ASSISTANCE

(1985 Data)

	7 or Less		8 to 14		15 to 17		More than 17		
STATE	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Total
ALABAMA	58	61.7%	17	18.1%	6	6.4%	13	13.8%	94
CALIFORNIA	46	85.2%	8	14.8%	0	0.0%	0	0.0%	54
GEORGIA	90	68.2%	24	18.2%	3	2.3%	15	11.4%	132
IDAHO	33	49.3%	23	34.3%	3	4.5%	8	11.9%	67
LOUISIANA	83	70.3%	24	20.3%	4	3.4%	7	5.9%	118
MICHIGAN	50	67.6%	19	25.7%	1	1.4%	4	5.4%	74
NEW YORK	62	67.4%	20	21.7%	2	2.2%	8	8.7%	92
NORTH CAROLINA	89	59.3%	38	25.3%	8	5.3%	15	10.0%	150
OHIO	51	83.6%	7	11.5%	1	1.6%	2	3.3%	61
SOUTH CAROLINA	34	50.0%	22	32.4%	5	7.4%	7	10.3%	68
VIRGINIA	52	63.4%	18	22.0%	7	8.5%	5	6.1%	82
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Totals	648	65.3%	220	22.2%	40	4.0%	84	8.5%	992

Table 3. **YEARS OF FARMER PROGRAM ASSISTANCE BY CLASSIFICATION**

(1988 Data)

Years Of Assistance	Loss	Doubtful	Sub-Standard	Standard	Commercial	TOTALS
New to 7						
Number	C. 80	133	B. 457	185	A.1 38	893
Percent	4.8%	8.0%	27.4%	11.1%	2.3%	53.5%
8 to 14						
Number	88	101	284	117	A.2. 22	612
Percent	5.3%	6.1%	17.0%	7.0%	1.3%	36.7%
15 to 17						
Number	6	7	57	14	A.3. 2	86
Percent	0.4%	0.4%	3.4%	0.8%	0.1%	5.2%
More than 17			D.			
Number	11	4	32	25	6	78
Percent	0.7%	0.2%	1.9%	1.5%	0.4%	4.7%
TOTALS	----	----	----	----	----	------
Number	185	245	830	341	68	1,669
Percent	11.1%	14.7%	49.7%	20.4%	4.1%	100%

Table 4. YEARS OF FARMER PROGRAM ASSISTANCE BY CLASSIFICATION

(1985 Data)

Years Of Assistance	Acquired/ Liquidate	Loss	Vulnerable	Sub-Standard	Standard	Commercial	TOTALS
New to 7	E.			B.		A.1	
Number	252	363	430	466	968	138	2,617
Percent	6.1%	8.8%	10.4%	11.3%	23.4%	3.3%	63.4%
8 to 14		C.				A.2	
Number	120	141	131	163	355	93	1,003
Percent	2.9%	3.4%	3.2%	3.9%	8.6%	2.3%	24.3%
15 to 17						A.3	
Number	9	16	15	32	83	33	188
Percent	0.2%	0.4%	0.4%	0.8%	2.0%	0.8%	4.6%
More than 17				D.			
Number	19	20	28	49	147	59	322
Percent	0.5%	0.5%	0.7%	1.2%	3.6%	1.4%	7.8%
TOTALS	----	----	----	----	------	----	------
Number	400	540	604	710	1,553	323	4,130
Percent	9.7%	13.1%	14.6%	17.2%	37.6%	7.8%	100%

Senator **Conrad**. We will be spending a lot of time together in the next few months. [Laughter.]

If you want to invite my wife and I over for dinner and some of the staff, I think we are available tonight.

Mr. **Johnson**. Very good.

Senator **Conrad**. We appreciate very much your time and especially your patience here this afternoon. If you would not mind, if you could stay with us and participate with some of these other witnesses, I think that might be useful.

Mr. **Johnson**. I will stay for a little bit, but I do need to leave by 4:30 in order to get the mail signed that gets out before my people leave this afternoon.

Senator **Conrad**. All right. Very good.

Mr. **Johnson**. I hope you can appreciate that.

Senator **Conrad**. Absolutely. Next we will hear from the General Accounting Office, John Harman, the Director, and other staff that he has with him. Welcome.

Mr. **Harman**. Thank you, Mr. Chairman.

Senator **Conrad**. Good to have you hear, John. If you would introduce additional members of your staff that are here, we would be happy to welcome them as well.

STATEMENT OF JOHN W. HARMAN, DIRECTOR, FOOD AND AGRICULTURE ISSUES, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON DC; ACCOMPANIED BY DENNIS J. DUQUETTE, DIRECTOR, CIVIL AUDITS, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION; JOHN HUNT, ASSISTANT DIRECTOR AND PAT SWEENEY, ASSIGNMENT MANAGER, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, GENERAL ACCOUNTING OFFICE

INTRODUCTIONS

Mr. **Harman**. On my left is Dennis Duquette. Dennis is Director of our Financial Audits, and he is responsible for the financial audits we have done of the Farmers Home Administration. He is with our Accounting and Financial Management Division. He is an accountant so hopefully he can answer some of your questions related to the figures in our report. Also on my right is John Hunt, and John is responsible for our work on farm credit issues, and to his right is Pat Sweeney. Pat has done the report that we are issuing today on the use of loan funds as well as some other work that we are doing for Chairman Leahy regarding the Agricultural Credit Act.

INTRODUCTION TO TESTIMONY

We are pleased to be here today to discuss our efforts examining Farmers Home Administration's (FmHA) farm loan programs and related issues. Since enactment of the Food Security Act in 1985, we have carried out a number of reviews of FmHA's programs and financial condition. In fact, counting the one that is being issued today, it is some 18 reports in that time period. We are issuing our most recent report, as I said, on the use of loan funds in fiscal 1988.

In summary, and I will be summarizing my statement, Mr. Chairman—it has been provided for the record—in summary, the continued deterioration in FmHA's financial condition, despite a general improvement in the overall agricultural economy, and the many problems faced by FmHA in carrying out its mission leads us to believe that the Congress needs to reexamine Farmers Home's role.

My prepared testimony makes several points.

CONGRESS NEEDS TO REEXAMINE FMHA'S ROLE

First, the financial condition of Farmers Home's farm loan portfolio, as was pointed out in the earlier discussion, has deteriorated to the point where about one-half of its $23 billion in outstanding direct farm loan principal is owed by delinquent borrowers and is vulnerable to future losses. In fiscal year 1988, Farmers Home reported $30.5 billion in unpaid principal and interest on its direct farm loan portfolio with an allowance for losses established at some $19 billion. Similarly, the unpaid principal in guaranteed farm loans totaled $3.6 billion with an allowance for losses established at $1.2 billion. Since its inception, the revolving fund from which all farmer program loans are made shows a cumulative deficit of nearly $29 billion.

Second, Farmers Home loanmaking policies have provided farm loans to borrowers who are unable to repay them and, as a result, borrowers require extensive loan servicing actions. In short, Farmers Home is on a loanmaking and servicing treadmill.

Third, rather than a source of temporary credit, Farmers Home has become a continuous source of subsidized credit for many farmer program borrowers. For example, as of September 30, 1989, and I will use the period of 10 years—you noted in our report that uses a 7 year period—but for loans that have been continuously for 10 years have been about 35 percent of all borrowers. The benefits Farmers Home borrowers receive are substantial. We estimated that during 1986 the Government interest rate subsidies received by farm program borrowers was between $600 million and $1.6 billion. We also estimated that the financial advantage gained from over other farmers who borrowed money from non-Farmers Home lenders amounted to between $1.2 billion and $2.2 billion in 1986.

Fourth, few direct farm loan borrowers have shifted to guaranteed farm loans, as you pointed out earlier. As a result and because these borrowers most likely will not shift because of their poor financial conditions, continuous substantial budget outlays will probably be needed to help them stay in business. In addition, the increase in outstanding principal for guaranteed loans has outpaced the decrease in that for direct loans by about $570 million between 1986 and 1988, thereby increasing government's overall financial exposure.

And finally, as a part of our ongoing work examining the Agricultural Credit Act, the implementation of that act for Chairman Leahy, we have provided examples of delinquent borrowers who have acted in bad faith, and we are also issuing, as I said, a report today showing how an estimated $2.2 billion in fiscal year 1988 FmHA loan funds were used. In short, the report shows that about one-third of these funds for direct and guaranteed loans combined were used to refinance existing debt. Guaranteed loans, in particular, were used for this purpose. Lenders are using guaranteed loans to enhance their loan security on existing debts rather than expanding borrowers' operations.

In addition, over 80 percent of the direct and guaranteed funds were received by existing Farmers Home borrowers or borrowers of the lenders who made guaranteed loans. With increasing shift to guaranteed loans, this situation could work against farmers starting operations or low income farmers.

Balancing the role of FmHA as both an assistance and a loanmaking agency is very difficult as the discussion you just had with Mr. Johnson indicates. It is a very difficult situation and requires basic policy decisions that only Congress can make. These decisions should consider such factors as the budgetary impacts, the extent to which credit assistance helps farmers who are facing extreme financial stress, the length of time that such credit should continue, the impact of continued credit on farmers' financial viability, and the implications of these decisions on rural communities.

We recognize that the Congress through recently passed legislation wants to continue to assist financially stressed farmers and keep them in business if at all possible. However, poor loanmaking decisions and the trend toward becoming a continuous source of credit raises fundamental questions regarding FmHA's mandate to serve as a temporary source of credit while at the same time fulfilling its role as a lender of last resort. We believe a reevaluation of Farmers Home's role and mission is needed. Without change the likely outcome is continued deterioration in Farmers Home farm loan portfolio and further losses.

EXAMINING SEVERAL KEY ISSUES

The Congress may wish to reevaluate the current and future role of Farmers Home by examining several key issues including: Are the continuation and debt restructuring policies the best means of assisting already heavily indebted farmers? At what point would the cost of providing continuous credit to financially marginal farmers outweigh the benefits to the farmer, the Government and rural communities? If Farmers Home is to serve as a temporary source of credit, should specific criteria be developed to decide when a borrower has had a sufficient opportunity to become financially sound and be in a position to graduate to non-Farmers Home sources of credit?

For those borrowers who after a period of time show little or no prospect for success, would it be more appropriate to provide other forms of assistance such as job training to aid in possible transition to other employment opportunities? And finally, in a period of budgetary pressures, should Farmers Home consider the extent to which assistance continues to be used by existing customers versus new customers and the level to which such assistance is used to refinance existing debt?

Mr. Chairman, that completes my summary. We would be pleased to answer any questions you have.

[The prepared statement and appendixes I-III of Mr. Harman follow:]

United States General Accounting Office

GAO Testimony

For Release on
Delivery
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Issues Surrounding the Role and Mission of the Farmers Home Administration's Farm Loan Programs

Statement of
John W. Harman, Director
Food and Agriculture Issues
Resources, Community, and Economic
Development Division

Before the
Subcommittee on Agricultural Credit
Senate Committee on Agriculture,
  Nutrition, and Forestry

GAO Form 160 (12/87)

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our efforts in examining the Farmers Home Administration's (FmHA) farm loan programs and related issues. Since enactment of the Food Security Act in December 1985, we have carried out a number of reviews of FmHA's programs and financial condition. We are issuing our most recent report on the use of FmHA's fiscal year 1988 loan funds today. Appendix I provides information about each of the 18 reports we have issued during this period. Many of these reports include matters for congressional consideration as well as recommendations to FmHA for program improvements.

In summary, the continued deterioration in FmHA's financial condition, despite a general improvement in the overall agricultural economy, and the many problems faced by FmHA in carrying out its mission leads us to believe that the Congress needs to reexamine FmHA's role. Specifically, our work has shown that:

- -- The financial condition of FmHA's farm loan portfolio has deteriorated to the point where about one-half of its $23 billion in outstanding direct farm loan principal is owed by delinquent borrowers and vulnerable to future losses. In addition, material internal accounting control weaknesses exist.

- -- FmHA's loan making policies have provided farm loans to borrowers who are unable to repay them and, as a result, borrowers require extensive loan servicing actions.

- -- Rather than a source of temporary credit, FmHA has become a continuous source of subsidized credit for many farmer program borrowers.

-- While funding emphasis has shifted from direct to guaranteed loans, most guaranteed loans are being made to existing commercial lender customers and few direct farm loan borrowers have shifted to guaranteed farm loans. Consequently, the government's overall financial exposure has increased.

My testimony also includes information about ongoing work and our recent reports examining certain aspects of the Agricultural Credit Act and the use of FmHA's loan funds.

Balancing the role of FmHA as both an assistance and a loan-making agency is difficult and requires basic policy decisions that can be made only by the Congress. These decisions should consider such factors as budgetary impacts, the extent to which farmers who are facing extreme financial stress can be helped by credit assistance, the length of time that such credit should continue, how such credit should be used, the impact of continued credit on farmers' financial viability, and the implications of these decisions on rural communities.

In any event, we believe a reevaluation of FmHA's role and mission is needed. Without change, the likely outcome is continued deterioration in FmHA's farm loan portfolio and further losses. We have identified several key issues the Congress may wish to consider as it deliberates FmHA's future role and mission in providing farm credit to the nation's distressed farmers.

FINANCIAL CONDITION OF FmHA'S FARM LOAN PORTFOLIO

Our reports on the financial condition of FmHA's farm loan portfolio[1] show that the outstanding principal in FmHA's direct farm loan programs,[2] as well as delinquencies and loan losses, have increased dramatically since the mid-1970s, placing the federal government and, ultimately the taxpayers, at considerable risk. The deterioration in FmHA's farm loan portfolio has continued despite the improvement in the overall farm economy. In addition, our financial audits of FmHA have uncovered material internal accounting control weaknesses.

Outstanding principal for FmHA's direct farm loan programs was about $5 billion as of June 30, 1976, and about $23.3 billion as of September 30, 1989.[3] Outstanding principal owed by delinquent borrowers was about $723 million in 1976 and about $11.1 billion as of September 30, 1989. Outstanding principal for FmHA guaranteed farm loans was about $484 million as of September 30, 1984, and about $3.2 billion as of September 30, 1989. Outstanding principal owed by guaranteed delinquent borrowers was about $135 million as of September 30, 1987, and about $197 million as of September 30, 1989. Tables 1 and 2 provide further information on FmHA's direct and guaranteed farm loans as of September 30, 1989.

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[1] Farmers Home Administration: An Overview of Farmer Program Debt, Delinquencies, and Loan Losses (GAO/RCED-86-57BR; Jan. 2, 1986); Farmers Home Administration: Farm Program Debt, Delinquencies, and Loan Losses as of June 30, 1987 (GAO/RCED-88-134BR; May 20, 1988); Financial Audit: Farmers Home Administration's Losses Have Increased Significantly (GAO/AFMD-89-20; Dec. 20, 1988); and Financial Audit: Farmers Home Administration's Financial Statements for 1988 and 1987 (GAO/AFMD-90-37; Jan. 25, 1990). The last two reports focus on all of FmHA's financial activities, including farm loan programs.

[2] FmHA's current major direct farm loan programs include farm ownership loans to buy and improve farm land and to construct, repair, and improve buildings; farm operating loans for feed, seed, fertilizer, livestock, farm and home equipment, living expenses, and seasonal hired labor; and emergency loans for actual losses caused by natural disasters.

[3] All fiscal year 1989 data used in this testimony is preliminary, unaudited, and subject to audit adjustment at a later date.

Table 1: FmHA Direct Farm Loans and Delinquency Status, September 30, 1989

Dollars in Millions

	Farm ownership	Farm operating	Emergency disaster	Economic emergency[a]	Other[b]	Total[c]
Total borrowers[d]	109,389	98,225	88,575	37,120	13,133	346,442
Delinquent borrowers[d]	23,775	35,006	35,082	17,267	3,607	114,737
Delinquent borrowers as a percent of total	21.7	35.6	39.6	46.5	27.5	33.1
Total outstanding principal	$7,046	$5,229	$7,683	$3,065	$259	$23,282
Outstanding principal owed by delinquent borrowers	$2,015	$1,940	$5,252	$1,818	$104	$11,130
Outstanding principal owed by delinquent borrowers as a percent of total	28.6	37.1	68.4	59.3	40.2	47.8

[a] These loans were authorized from 1978 to 1984; the program has not been authorized since September 30, 1984.

[b] This category includes all other individual direct farm loans, such as soil and water loans to help farmers and ranchers develop, conserve, and properly use land and water resources.

[c] Totals may not add due to rounding.

[d] This table presents data by loan type rather than individual borrower, which results in borrowers being counted in each loan category in which they have a loan.

Source: GAO analysis of FmHA Active Borrowers Delinquent Report data (FmHA report code 616).

Table 2: FmHA Guaranteed Farm Loans and Delinquency Status, September 30, 1989

Dollars in Millions

	Farm ownership	Farm operating	Other[a]	Total
Total borrowers[b]	5,549	23,670	797	30,016
Delinquent borrowers[b]	300	1,063	217	1,580
Delinquent borrowers as a percent of total	5.4	4.5	27.2	5.3
Total outstanding principal	$772	$2,371	$101	$3,244
Outstanding principal owed by delinquent borrowers	$44	$120	$33	$197
Outstanding principal owed by delinquent borrowers as a percent of total	5.7	5.1	32.7	6.1

[a] This category includes all other guaranteed farm loans, such as emergency livestock loans.

[b] This table presents data by loan type rather than individual borrower, which results in borrowers being counted in each loan category in which they have a loan.

Source: GAO analysis of FmHA Analysis of Delinquencies Report data (FmHA report code 4067).

The cumulative results of operations for FmHA's Agricultural Credit Insurance Fund (ACIF)--the revolving fund from which all farmer program loans are made--shows a multibillion dollar accumulated deficit since it was established in 1946. Our January 25, 1990, report--Financial Audit: Farmers Home Administration's Financial Statements for 1988 and 1987--shows that the ACIF has incurred cumulative net losses of about $39.6 billion since its inception, while receiving cumulative reimbursements for losses (appropriations from the Congress) of about $11 billion. The cumulative results of operations for the ACIF as of September 30, 1988, was a deficit of $28.6 billion.

A significant portion of the nearly $40 billion in cumulative net losses for the ACIF was recognized by FmHA during fiscal years 1987 and 1988 when FmHA increased its allowances for loan and related interest losses by a net $10.6 billion and $2.9 billion, respectively. During 1987, FmHA initially established an allowance for loan losses, to conform with generally accepted accounting principles, which resulted in unusually high adjustment for losses being charged to fiscal year 1987 expenses. The adjustment for losses in 1987 was not attributable to a single adverse event in 1987, but was the cumulative effect of the declining trend in the agricultural economy over the past several years. Consequently, the 1987 adjustment for losses on loans included both a provision for 1987 and an adjustment for prior years' losses.

As the January 25, 1990, report shows, in fiscal year 1988, FmHA reported $30.5 billion in unpaid principal and interest on the ACIF's direct farm loan portfolio. The allowance for losses established for the direct farm loan portfolio totaled $19.0 billion, or 62 percent of the unpaid principal and interest. FmHA also reported that the guaranteed unpaid principal on the ACIF's guaranteed farm loans totaled $3.6 billion. The allowance for losses established for the guaranteed farm loan portfolio totaled $1.2 billion, or 33 percent of the guaranteed unpaid principal.

In our latest report on FmHA's system of internal accounting controls, we noted material weaknesses in the loan classification system used to estimate losses on individual farm loans. Changes are needed to correct these weaknesses so that future loss provisions are properly estimated. Furthermore, our report discloses the following material internal accounting control weaknesses related to acquired property: (1) FmHA's Acquired Property Tracking System contained inaccurate and incomplete information, (2) FmHA has not completed system modifications which would allow it to properly record acquired property at fair market value or to record the associated gain or loss at the time of acquisition, and (3) FmHA has not developed a methodology for determining property holding and disposition cost factors for estimating loan losses and for computing the acquired property balance. Our opinion on FmHA's fiscal year 1988 financial statements is qualified for these reasons. Our report includes recommendations to correct each problem area.

While FmHA has made progress in improving the financial management of its operations, there ~~remain~~ several areas of concern. The agency's financial management systems do not provide the kind of cost information that program managers need to effectively evaluate the results of their decisions. There is also a need for more effective accountability reporting. The preparation and audit of annual financial statements is now in its third year. This provides excellent financial management discipline and deterrence to waste and mismanagement, and we strongly recommend continuance of this practice.

FmHA LOAN-MAKING AND LOAN-SERVICING POLICIES AND PRACTICES

The major report we issued relating to FmHA's loan-making and loan-servicing policies and practices[4] shows that, as directed by congressional action, FmHA has placed heavy emphasis on keeping farmers in business. In short, FmHA is on a loan-making and servicing treadmill. Optimistic loan-making decisions--which are based on a cash flow analysis that does not consider contingencies or equipment replacement and tends to overstate income--are followed in many instances by the need for servicing actions, such as rescheduling, and additional loans, which are also based on optimistic cash flow projections. Often borrowers cannot repay the initial loan or the subsequently serviced loan and the cycle continues.

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[4] *Farmers Home Administration: Sounder Loans Would Require Revised Loan-Making Criteria* (GAO/RCED-89-9; Feb. 14, 1989).

FmHA was established to serve as the "lender of last resort" for family farmers unable to obtain credit elsewhere at reasonable rates and terms. It has traditionally played a critical role in helping financially stressed farmers stay in business. Assistance is obtained through loans that are expected to be repaid to protect the government's and ultimately the taxpayers' interests. FmHA must balance how much credit, if any, should be provided while maintaining fiscal responsibility. If FmHA makes loans to borrowers with little chance of repayment, it lessens its fiscal responsibility. In addition, the resulting loans may erode borrower equity and ultimately lead to the financial failure of the borrower and government losses. Conversely, if FmHA's loan-making criteria are too stringent, the agency will limit assistance to financially stressed farmers and perhaps force many out of business.

Recent congressional direction has generally been aimed at keeping financially stressed farmers in business. For example, in July 1987 the Congress directed FmHA to reinstate the "continuation policy" rescinded by FmHA in November 1985. This policy allows existing borrowers to obtain additional FmHA operating loans without showing the ability to repay prior loans. The Congress also enacted the Agricultural Credit Act of 1987 that directed FmHA to consider reducing delinquent borrowers' debt if, because of inadequate collateral, it was better financially for the government than loan foreclosure and liquidating borrowers' assets.

In making loan decisions, FmHA uses a cash flow criterion that requires borrowers' expected revenues to cover projected expenses, including loan repayment. However, we found that because optimistic financial data are used, FmHA's cash flow analysis has frequently been unreliable for determining loan repayment ability and, by itself, is not a good indicator of creditworthiness. For example, although not projectable, a review of 100 of 160 randomly selected borrowers' files (for which sufficient financial data were available) showed that repayment ability and cash farm income had been overstated, on average, by about 24 percent and over 18 percent, respectively.

As a result, borrowers often cannot make their scheduled payments and require extensive servicing actions, such as reducing interest rates or increasing the repayment period. For example, FmHA made a total of 414 loans in 1986 to our sample of 160 borrowers. Of this number, 264 loans, or about 64 percent, were servicing actions on loans originally made prior to 1986. These prior loans involved a total of 469 servicing actions--264 actions in 1986 and 205 actions before 1986 (each servicing action resulted in a new loan)--the average time between servicing was 2.8 years and the final scheduled payment date was lengthened an average of 8 years. One loan had gone through nine servicing actions over a period of about 4.5 years.

We updated selected data for the 414 loans made to the 160 sampled borrowers. As of September 30, 1989, 116 loans, or 28 percent of the 414 loans, had been serviced by rescheduling, reamortization, or consolidation. Another 41 loans, or 10 percent, were no longer active because the borrowers were in bankruptcy, had debt settled, or, under the provisions of the Agricultural

Credit Act, had bought out of their FmHA debt at the net recovery value of the collateral.

A consequence of extensive loan servicing is that short-term debt that has repayment periods extended several times eventually becomes long-term debt. This long-term debt may no longer be adequately secured. FmHA does not require additional security for serviced loans, even if the original security is no longer adequate. These actions help temporarily but frequently result in heavier debts and reduced borrower equity, which in the long run weaken the borrower's financial condition. Loan servicing also has a financial impact on the government. FmHA has estimated that implementation of the debt restructuring provisions of the Agricultural Credit Act will result in about $9.4 billion in FmHA farmer program debt being written down or written off.

In January 1987, FmHA proposed revised criteria to improve its loan-making decisions. The proposed criteria, which included a credit-scoring system, attempted to ensure that FmHA made loans to borrowers who had a reasonable chance of repaying their debt. Current loan-making criteria, as modified by the continuation policy, do not attempt to sort out or adequately identify existing borrowers who will likely not survive financially even with additional FmHA assistance.

While the credit-scoring system as originally proposed could have denied assistance to a large percentage of existing FmHA borrowers, it attempted to draw the line between those financially troubled farmers who could be helped and those who could not be helped with FmHA loans. It also identified the degree of risk associated with each borrower and loan, something not disclosed under the cash flow requirement.

Congressional concern over the potential denial of further assistance to many borrowers as a result of the credit scoring system, the lack of a published impact study, and the relatively short comment period that FmHA provided interested parties eventually led to FmHA's withdrawal of the proposed criteria. However, in the Agricultural Credit Act of 1987, the Congress allows for future revision of certain FmHA loan-making criteria if the agency adequately studies the impact of such a revision on its borrowers and provides appropriate congressional committees with sufficient time to review the results.

On September 28, 1989, FmHA awarded a contract to conduct a study of loan approval and borrower selection criteria. The study is scheduled for completion in May 1990. The agency has indicated that when the study is completed, FmHA will (1) evaluate the results and revise its regulations as appropriate and (2) consult with the Congress early and often on the study to obtain congressional support for the necessary changes in loan approval and borrower selection criteria.

TIME PERIOD FOR PROVIDING CREDIT ASSISTANCE

Our work[5] has also shown that authorizing legislation and implementing regulations governing FmHA's farm loan programs mandate that the agency is to be a temporary source of credit and that borrowers graduate to non-FmHA sources of credit when they are able to do so. However, FmHA has evolved into a continuous source of subsidized credit for nearly one-half of its borrowers. For example, as of December 31, 1986, nearly 112,000 borrowers, about 42.5 percent of all FmHA direct farm loan borrowers at that time, had had at least one active loan continuously for 7 years or more. This included about 57,600 borrowers (about 22 percent) who had had at least one loan continuously for 10 years or more.

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[5] Farmers Home Administration: Farm Loan Programs Have Become a Continuous Source of Subsidized Credit (GAO/RCED-89-3; Nov. 22, 1988).

As table 3 shows, the total percentage of borrowers that have had at least one FmHA loan continuously for 7 years or more has remained unchanged at 42.5 percent. A major change, however, was in the 10 years or more category which increased from about 22 percent in 1986 to about 35 percent in 1989.

Table 3: Number of Years of Involvement in FmHA's Farmer Programs and Number of Loans Received for All Active Borrowers as of September 30, 1989

Years in FmHA	Number of borrowers	Percent of total	Number of loans received	Percent of total
0 to 3	34,079	16.0	76,330	12.4
3 to 5	53,872	25.3	154,615	25.2
5 to 7	34,261	16.1	102,326	16.7
Total under 7	122,212	57.4	333,271	54.3
7 to 10	16,342	7.7	48,298	7.9
10+ over	74,276	34.9	231,943	37.8
Total over 7	90,618	42.5	280,241	45.6
Not determined[a]	224	.1	503	.1
Total	213,054	100.0	614,015	100.0

[a] We excluded from our calculations loans with a closing date prior to 1954 and those where data were not available.

Source: GAO analysis of FmHA data.

Over the past several decades, FmHA's temporary credit role and graduation mandate have been deemphasized in favor of a policy of keeping farmers in business for long periods regardless of their financial condition. This has been accomplished in a variety of ways that involved all three branches of the government. For example, the congressionally approved continuation policy keeps farmers in business with new loans even if they cannot show an ability to repay all outstanding debts. FmHA provides continuous servicing of loans to keep farmers in business. And the courts, through various orders and injunctions, temporarily suspended FmHA foreclosure actions in the past until FmHA clarified certain notices and procedures for its borrowers.

While FmHA has been successful in keeping farmers in business, it has not been without cost. For example, in our November 1988 report we estimated that during 1986 the government interest rate subsidies received by FmHA farm program borrowers--the difference between the interest rate charged the farmer and the interest cost the government incurred to obtain the funds it loaned--was between $612 million and $1.6 billion. FmHA borrowers also have a financial advantage over other farmers who must pay higher interest rates to borrow money from non-FmHA lenders. We estimated this advantage amounted to between $1.2 billion and $2.2 billion during 1986.

For example, after 15 years in FmHA's farm loan programs, a farmer, raising corn, soybeans, and cattle, had received 39 loans. He had 14 loans with a balance of $435,790 outstanding as of December 31, 1986. For 38 loans on which we could develop reliable histories from FmHA files, FmHA had taken 17 loan servicing actions, including rescheduling, reamortization, and debt set-aside. The 38 loans ranged from $2,500 to $90,524 and totaled $501,357. We estimated in constant 1986 dollars that the borrower had received $49,053 in government interest rate subsidies and $98,141 in financial advantage over non-FmHA farm borrowers. Despite FmHA assistance, the borrower's reported net worth declined from $20,368 in 1971 to a negative $6,635 in 1986.

SHIFT FROM DIRECT TO GUARANTEED FARM LOANS

Since 1984, FmHA has been shifting its farm lending from direct to guaranteed farm loans. This shift was authorized by the Food Security Act and subsequent appropriations. Our September

1989 report[6] showed that the increase in guaranteed lending--from about $71 million to $1.3 billion between fiscal years 1983 and 1988--has resulted primarily from private lenders obtaining loan guarantees for their existing customers who had become financially stressed rather than existing FmHA direct borrowers obtaining guaranteed loans. Our analysis of FmHA loan data showed that only 2 percent of the borrowers with direct farm operating and/or ownership loans between 1985 and 1987 also obtained the same type of guaranteed farm loans.[7] Direct lending declined--from about $2.4 billion to $1.0 billion between fiscal years 1983 and 1988--primarily because of earlier availability of government farm program payments, fewer borrowers, reduced farm operating expenses, and reduced direct farm ownership lending authorizations.

The impact of the shift to guaranteed lending varies among borrowers, lenders, and the government and cannot be easily measured. Although guaranteed loans help high-risk borrowers obtain credit from private lenders on better loan terms, these borrowers have higher costs of money, stricter loan terms, and, at the time of our work, greater likelihood of liquidation because of lender policies than do FmHA direct loan borrowers. These factors are disincentives for direct loan borrowers to seek guaranteed loans. Guaranteed loans benefit lenders by reducing financial risk and loan losses, improving liquidity and profitability from selling the guaranteed portion of loans in the secondary market, and upgrading the classification of their loan portfolios with bank regulators.

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[6] Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86; Sept. 11, 1989).

[7] This analysis was further supported by the U.S. Department of Agriculture's Office of Inspector General in a September 1988 report that projected that about 1 percent of the 15,585 guaranteed farm loans totaling $1.5 billion in its sample universe were used to finance FmHA direct loan borrowers.

The impact of the shift on the government is mixed. The increase in guaranteed lending has helped keep some farm lending in the private sector and reduce budgetary outlays needed to make new direct loans. However, because few direct loan borrowers have switched to guaranteed loans, and most likely will not because of their poor financial conditions, continued substantial budget outlays will probably be needed to provide financing to help them stay in business. In addition, the increase in outstanding principal for guaranteed loans has outpaced the decrease in that for direct loans, by about $570 million between fiscal years 1986 and 1988. Consequently, despite the progress in shifting from direct to guaranteed lending, the government's overall financial exposure has increased.

While FmHA's guaranteed farm operating and ownership loan activity has significantly increased since 1984, losses on these loans have grown at a faster rate. Loan delinquencies are also growing, and FmHA projects that losses on guaranteed loans will increase in the future.

Because lenders generally obtain guarantees on loans for financially stressed farmers, losses on such loans can be expected. Although some loan losses may be attributable to uncontrollable factors, such as adverse weather conditions and a poor farm economy, problems in FmHA's assessment of borrowers' financial conditions prior to guarantee loan approval and in FmHA's oversight of lenders' servicing of guaranteed loans after approval have also contributed to guaranteed loan losses. These problems are similar to those that FmHA has with its direct farm loans. As the shift continues from direct to guaranteed farm loans, correcting the problems with the guaranteed loan program grows in importance: to control the mounting losses, prevent the loss of the shifts' budgetary advantage, and avoid the experience with the direct loan program.

In our September 1989 report we included three case studies on borrowers who had defaulted on FmHA-guaranteed loans to illustrate many of the problems we identified. The three case studies are included as appendix II.

CONTINUING EFFORTS TO EXAMINE SIGNIFICANT FmHA ISSUES

Our work on FmHA issues is continuing. For example, we are examining (1) implementation of the debt restructuring provisions of the Agricultural Credit Act (report expected in the spring of 1990), (2) farm program debt, delinquencies, and loan losses as of June 30, 1989 (report expected in the spring of 1990), (3) controls for identifying and reporting cases of fraud, waste, and abuse in FmHA's farm loan programs, (4) the selling price for farm inventory properties, and (5) FmHA's fiscal year 1989 financial statements. We plan to report the results of the last three assignments later in 1990. In addition, we are issuing our latest report today on the use of FmHA loan funds by farmer program borrowers.

As part of our work examining the Agricultural Credit Act, we issued Farmers Home Administration: Loan Servicing Benefits for Bad Faith Borrowers (GAO/RCED-90-77FS; Nov. 29, 1989). This report provides examples of FmHA delinquent borrowers who have acted in bad faith[8] and who have received benefits, or will be eligible to receive benefits, under the provisions of the act.

FmHA determined that borrowers acted in bad faith because of various actions, such as (1) selling or otherwise disposing of property securing loans without FmHA approval; (2) repaying other lenders more than required and, at the same time, becoming delinquent on FmHA loans; (3) abandoning the property securing FmHA loans; and (4) having resources available that could have been, but were not, used to make FmHA loan payments. In appendix III we include the eight case examples from our November 1989 report to illustrate FmHA bad faith determinations and how bad faith borrowers benefited, or will be eligible to benefit, under the terms of the Agricultural Credit Act.

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[8] We use the phrases "borrowers who act in bad faith" and "bad faith borrowers" to refer to those FmHA delinquent borrowers whose delinquency was due to circumstances within their control or who did not act in good faith in connection with the terms of their FmHA loans.

In January 1990, FmHA provided members of Congress with a list of 218 bad faith borrowers throughout the country that it said had committed fraud, waste, or conversion of security property and who were involved in net recovery value buyouts. Forty-two of those borrowers had bought out their debt at a net recovery value and 58 other borrowers were in the process of buying out their debt. These 100 borrowers include 8 borrowers who bought out or were in the process of buying out their debt that will result in a write off of more than $1 million each. For example, one borrower with proven fraud owed FmHA $11.8 million and was offered a $1.1 million net recovery value buyout. This borrower will receive a $10.7 million write off of his FmHA debt if he pays the buyout amount. In addition, 118 borrowers on the national list were offered net recovery value buyout, but they did not accept the buyout offer. These borrowers will be eligible to reacquire their farmland, or farm homestead, if FmHA forecloses on their properties.

The report we are issuing today[9] shows how an estimated $2.2 billion in fiscal year 1988 FmHA loan funds were used.[10] The report focuses on four types of farmer program loans (direct farm ownership loans, direct farm operating loans, guaranteed farm ownership loans, and guaranteed farm operating loans) and the extent to which loan funds were used to refinance farmers' existing debts. Also, the report contains information on guaranteed farm loans based on interviews of commercial lenders who made loans that FmHA guaranteed.

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[9] Farmers Home Administration: Use of Loan Funds by Farmer Program Borrowers (GAO/RCED-90-95BR; Feb. 8, 1990).

[10] Loan use information is based on a randomly selected sample of loans which was used to estimate various loan characteristics. Also, the information is based on borrowers' planned uses of loan funds and statements regarding use refer to the planned use.

Our analysis of the fiscal year 1988 loans showed that approximately 50 percent, or $1.1 billion, was used for farm operating expenses; 30 percent, or $665 million, was used to refinance existing debts; and 6 percent, or $131 million, was used to purchase farm property. The remaining 14 percent, or $310 million, was used for a variety of other purposes, such as purchasing machinery, equipment, and livestock and improving real estate. Our analysis also showed that $1.8 billion, or 81 percent, of the funds were received by existing FmHA borrowers or borrowers of the lenders who made loans that FmHA guaranteed.

In the report, we discuss how FmHA farm ownership and operating loans are authorized for a variety of purposes without prioritization or preference for a particular purpose. As a result, loan funds are used for any authorized purpose if eligibility, repayment ability, and security requirements are met. Also, while there is no preference in the processing of applications, use of funds, or the recipient of funding, FmHA told us that county offices have been advised that approved loans for certain types of borrowers, such as limited resource borrowers, may receive funds before other types of borrowers.

Our work showed that the level of refinancing that occurred in fiscal year 1988 indicates that lenders are using guaranteed loans to enhance their loan security on existing debts rather than to expand borrowers' operations. In addition, while some commercial lenders use the guaranteed programs for new customers, this use is limited. Some commercial lenders do not make guaranteed loans, and consequently their customers are not offered the option of a guaranteed loan for refinancing existing debts or for other purposes.

The use of loan funds is influenced by the lender--FmHA for direct loans and commercial lenders for guaranteed loans. FmHA influences the use of direct loans by trying to shift new borrowers and loans for refinancing to guaranteed loans. Although FmHA approves loan guarantees, commercial lenders decide whether or not to seek a guarantee on loans they make. Therefore, the use of guaranteed loans is largely determined by commercial lenders. Under this scenario, farmers who are not existing customers of commercial lenders using guaranteed loans may be effectively excluded from participating in FmHA's farmer loan programs. This may include farmers starting operations or low-income farmers.

MATTERS FOR CONGRESSIONAL CONSIDERATION

FmHA has the difficult task of achieving its assistance goals while also employing sound loan-making policies. Although the Congress and FmHA have used existing credit policies as a means of keeping farmers in business and assisting rural communities, the Congress may want to examine the long-term effect such policies have on borrowers.

FmHA and its borrowers need to realistically assess borrowers' chances of financial recovery before they lose additional equity through continued borrowing. Additional loans to farmers who cannot repay them have resulted in a decline in the borrowers' equity position, the deterioration of the financial condition of FmHA's farm loan portfolio, and increased government loan losses. To this end, we recommended that FmHA develop, in consultation with the Congress, a more comprehensive loan-making criteria for both direct and guaranteed farm loans that assess an applicant's financial solvency, profitability, liquidity, and repayment ability prior to making new loans. This will assist borrowers by providing them with a more realistic assesment of their financial condition before they accept additional credit, and also help improve the financial condition of FmHA's farm loan portfolio.

We recognize that the Congress, through its recently passed legislation, wants to continue to assist financially stressed farmers and keep them in business if at all possible. However, the use of a cash flow criterion in loan-making decisions and the trend toward becoming a continuous source of credit raises fundamental questions regarding FmHA's mandate to serve as a temporary source of credit while, at the same time, fulfilling its role as a lender of last resort. The report we are issuing today also raises questions as to whether limited federal assistance should be directed to (1) certain types of borrowers, such as new or limited resource operators, or (2) certain credit purposes, such as purchasing farm property or funding operating expenses.

In addition, shifting funding from direct to guaranteed farm loans will not solve FmHA's problems. With the increased credit costs and the greater risk of liquidation associated with guaranteed loans, coupled with direct loan borrowers' poor financial conditions, it is unlikely that significant numbers of direct loan borrowers will shift to guaranteed loans in the future. If direct loan funding continues to decline and delinquent direct loan borrowers continue to request direct loan financing under recent congressional initiatives, funding may not be sufficient to meet future credit needs of all direct loan borrowers.

As we have reported, the Congress may wish to reevaluate the current and future role of FmHA by examining several key issues, including the following:

-- Are the continuation and debt restructuring policies the best means of assisting already heavily indebted farmers?

-- At what point will the cost of providing continuous credit assistance to financially marginal farmers--including the cost of loan losses, interest rate subsidies, and administrative expenses--outweigh the benefits to the government, rural communities, and the farmer?

-- If FmHA is to serve as a temporary source of credit, should specific criteria be developed--such as time limits and/or measurable financial improvement--to decide when a borrower has had a sufficient opportunity to become financially sound and be in a position to graduate to non-FmHA sources of credit?

-- For those borrowers who, after a period of time, show little or no prospect for succeeding, would it be more appropriate to provide other forms of assistance, such as job training, to aid in possible transition to other employment opportunities?

-- In a period of budgetary pressures, should FmHA consider the extent to which assistance continues to be used by FmHA and commercial lender existing customers versus new customers and the level to which such assistance is used to refinance existing debts versus new credit purchases?

In the final analysis, decisions concerning FmHA's future role and mission will require congressional judgments about complex, and sometimes competing, objectives. We believe the work we have completed to date and the work that is underway will aid the

Congress as it deliberates how best to provide farm credit assistance to the nation's distressed farmers.

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Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions.

OVERVIEW OF RECENT GAO REPORTS HIGHLIGHTING FmHA ISSUES

Since December 1985, GAO has issued 18 reports that highlight various FmHA issues. The following brief description provides the report title, number, and date, and summary information from each report.

Farmers Home Administration: An Overview of Farmer Program Debt, Delinquencies, and Loan Losses (GAO/RCED-86-57BR; Jan. 2, 1986)

As requested by the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, this briefing report provides information on the financial condition of the FmHA loan portfolio for its five major farmer loan programs: farm ownership, operating, emergency disaster, economic emergency, and soil and water. Specifically, this report provides both national and state information on (1) total farm debt and FmHA's portion of that total, (2) total number of loans and borrowers and loan amounts for each of FmHA's major farmer programs, and (3) delinquencies and loan losses occurring in these programs.

The financial condition of farmers and their lenders had deteriorated rapidly between 1980 and 1985. As a result, increasing numbers of farmers were turned down for financing by their private lenders and came to FmHA for credit assistance. FmHA responded to these credit requests by substantially increasing its loan portfolio. At that time, FmHA's major farmer program loan portfolio was increasingly becoming at risk because delinquencies were on the rise and loan losses were mounting.

Farmers Home Administration: Financial and General Characteristics of Farmer Loan Program Borrowers (GAO/RCED-86-62BR; Jan. 2, 1986)

The Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, expressed concern over the American farmers' growing reliance on the resources of FmHA. He noted that FmHA's outstanding farm loan portfolio had increased from about $6 billion in 1978 to almost $28 billion in 1985. With the Congress addressing the issue of financial stress in U.S. agriculture, including FmHA's future role in assisting additional farmers, he asked GAO to inform the Committee of the current financial condition of both FmHA borrowers and the farm loan portfolio. This report and another report entitled Farmers Home Administration: An Overview of Farmer Program Debt, Delinquencies, and Loan Losses (GAO/RCED-86-57BR; Jan. 2, 1986) responded to his request.

At the time that this work was performed, FmHA had a computerized data base, the Farmer Program Management Information

System (FARMS), that contained certain financial and general characteristics of borrowers, such as debt load and cash flow, the type and size of farm operations, and demographic data. FARMS,[1] started in 1983, used information obtained from FmHA loan documents on borrowers who had received loans for (1) farm ownership, (2) annual operating expenses, (3) emergency disaster losses, and (4) soil and water development and conservation. Although FARMS did have some limitations, at that time it was the most complete source of financial information available on FmHA borrowers. FmHA said this information was representative of all FmHA farmer program borrowers on a national basis but was not projectable to individual states or counties.

This briefing report presents information on a total of 65,893 FmHA borrowers who received 117,366 farm loans during 1983 and 1984 (about 53 percent of all farm loans made during that period). The report provides information on borrower assets and liabilities, debt-to-asset ratios, and equity positions; discusses the cash flow position of the borrowers; provides general characteristics of borrowers including farm type, size, and demographic data; and provides our observations related to our analyses of the FARMS data.

Farmers Home Administration: Debt Restructuring Activities During the 1984-85 Farm Credit Crisis (GAO/RCED-86-148BR; May 16, 1986)

As requested by the Chairman, Subcommittee on Administrative Practice and Procedure, Senate Committee on the Judiciary, and Congressman Cooper Evans, this briefing report provides information on FmHA's debt restructuring activities with private lenders to meet the 1984-85 farm credit crisis.

The report has four major sections and contains (1) a description of FmHA's debt restructuring activities, including the loan programs and types of loans used to help farmers restructure their farm debt; (2) information on the magnitude of FmHA debt restructuring and the substantial increase in this activity between fiscal years 1984 and 1985; (3) case-study profile information on borrowers' farm income, debt-to-asset ratios, average loan amounts, and other related financial statistics in four FmHA county offices; and (4) comments from FmHA officials, national banking associations, and local lending institutions across six states on why private lenders were or were not participating in FmHA's debt restructuring activities.

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[1] The FARMS data base no longer exists.

Farmers Home Administration: Federally Acquired Farm Property Presents a Management Challenge (GAO/RCED-86-88; June 13, 1986)

This report is addressed to five congressional requesters and discusses the large number of farms that FmHA had acquired as a result of loan foreclosures and other actions. The report also discusses FmHA's management of this farm property, and the procedures used to sell or lease the property.

In the report, GAO projected that FmHA would lose about $190 million on the 1,270 properties in the 6 states reviewed. These losses would occur primarily because the value of the acquired properties will be less than the defaulted-borrowers' unpaid indebtedness and the cost of acquiring, managing, and selling the properties. GAO made several recommendations to the Secretary of Agriculture aimed at improving FmHA's selling efforts for inventory property, reducing the time that reserved properties are held for sale to only FmHA-eligible farmers, and prohibiting farmers from growing surplus crops on FmHA-leased properties.

Farmers Home Administration: Loan-Servicing Efforts Focus on Continually Delinquent Borrowers (GAO/RCED-87-13BR; Nov. 12, 1986)

The briefing report is addressed to the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, and provides information on the extent that FmHA borrowers were continually delinquent on their farm loans (defined as borrowers that were delinquent as of June 30 in each of 3 consecutive years--1984, 1985, and 1986). The report shows the following:

--Of approximately 261,000 total FmHA farm borrowers, 50,033 were continually delinquent. About 34,600 of these borrowers, or 13 percent of the total farm borrowers, accounted for 78 percent of the total $6.8 billion delinquent payments owed FmHA as of June 30, 1986.

--Of the 50,033 continually delinquent borrowers, 8,043 had discontinued or were discontinuing farming as of July 1986. According to FmHA records, 41,983 of the remaining delinquent borrowers were still actively farming. Information was not available on the status of the other seven continually delinquent borrowers.

--Of the 41,983 continually delinquent borrowers actively farming, 25,441 had not made a loan payment on at least one loan since 1983 or earlier, and 1,364 had never made a payment on any of their FmHA loans.

--Emergency disaster loans accounted for 63 percent of the total delinquent amounts owed by the 41,983 active continually delinquent borrowers.

Farmers Home Administration: Information on Agricultural Credit Provided to Indians on 14 Reservations (GAO/RCED-87-79BR; Mar. 11, 1987)

This briefing report is addressed to the Chairman, Senate Select Committee on Indian Affairs, and Senator John Melcher and provides information concerning the potential loss through foreclosure of reservation land used by Indians as collateral when obtaining FmHA farm loans. This work resulted in obtaining agricultural credit information from 14 specified reservations in Montana, North Dakota, and South Dakota.

The report provides statistics on past, current, and predicted losses of land pledged by Indian borrowers as security for FmHA farm loans; a description of options available to help Indians avoid the loss of reservation land; historical information about the use of the Indian Tribal Land Acquisition Program and information about tribal interest in its future use; a summary of the working relationship between FmHA and the Bureau of Indian Affairs (BIA) in issuing, servicing, and foreclosing on FmHA farm program loans to Indian borrowers; and FmHA and BIA views on possibly shifting FmHA loan functions to BIA for farm loans made to Indians.

Farmers Home Administration: Problems and Issues Facing the Emergency Loan Program (GAO/RCED-88-4; Nov. 30, 1987)

This report is addressed to the Ranking Minority Member, Subcommittee on Agriculture, Rural Development, and Related Agencies, Senate Committee on Appropriations, and discusses how the FmHA emergency loan program evolved over the previous several years, why its delinquency rate was so high, what alternatives were available to deal with debt that may be uncollectible, and any changes needed in legislation and/or program regulations to make it function more effectively. The report contains no recommendations for legislative or program changes, in large part, because, at that time, changes in legislation and FmHA loan policies should have resolved many of the program's past problems. The report does include issues for congressional consideration and raises questions about whether credit, particularly liberal credit, is the proper vehicle for providing disaster relief to farmers.

Farmers Home Administration: Farm Program Debt, Delinquencies, and Loan Losses as of June 30, 1987 (GAO/RCED-88-134BR; May 20, 1988)

This report is addressed to Senator Kent Conrad and provides updated information on FmHA's farm loan program debt, delinquencies, and loan losses that was included in our January 1986 report entitled, Farmers Home Administration: An Overview of Farmer Program Debt, Delinquencies, and Loan Lossess (GAO/RCED-86-57BR; Jan. 2, 1986). The report shows the financial condition of FmHA's farm loan portfolio as of June 30, 1987, for FmHA's five major farm loam programs: farm ownership, operating, emergency disaster, economic emergency, and soil and water. Specifically, the report provides both national and state information on (1) total farm debt and FmHA's portion of that total, (2) total number of loans and borrowers and loan amounts for each of FmHA's major farm programs, and (3) delinquencies and loan losses occurring in these programs.

Farmers Home Administration: Farm Loan Programs Have Become a Continuous Source of Subsidized Credit (GAO/RCED-89-3; Nov. 22, 1988)

As requested by Senator Jesse Helms, Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry at the time of his request, this report determines (1) if FmHA is graduating borrowers as intended, (2) whether FmHA has evolved into a long-term source of credit, and (3) the amount of government interest rate subsidy and financial advantage received by FmHA borrowers. The message of this report is discussed in the overall testimony.

Financial Audit: Farmers Home Administration's Losses Have Increased Significantly (GAO/AFMD-89-20; Dec. 20, 1988)

This report is addressed to the Secretary of Agriculture and presents the results of our examination of FmHA's financial statements for the year ended September 30, 1987, and our reports on internal accounting controls and compliance with laws and regulations.

The financial statements reflect a significantly deteriorating financial condition at FmHA for several reasons: (1) FmHA lends money at interest rates far below what it must pay, (2) many of its borrowers are, by commercial standards, not creditworthy, (3) a severe decline in the agricultural economy over the previous several years has led to congressional initiatives aimed at keeping farmers in business, and (4) many of the loans are delinquent and unlikely to be repaid.

Because of FmHA's operating losses, its accumulated deficit of $36 billion, and its present reliance on Treasury borrowings to continue operations, we are concerned that FmHA will require direct assistance from the Congress at levels significantly greater than the Congress has provided in the past. FmHA borrowed $12 billion from the Treasury in fiscal year 1987 to meet current obligations. The total amount due to the Treasury has steadily increased from about $60 billion in 1982 to $85 billion in 1987, of which $24 billion was due by 1989.

Our opinion on FmHA's statement of financial position reflects our concerns over the agency's inability to repay its borrowings and to meet its current operations without incurring additional debt and the magnitude of its accumulated $36 billion deficit, which includes $22 billion for losses recognized in fiscal year 1987. Furthermore, our opinion is qualified because FmHA does not record property received by voluntary conveyance at fair market value at the time of acquisition in accordance with generally accepted accounting principles for federal agencies.

Farmers Home Administration: Sounder Loans Would Require Revised Loan-Making Criteria (GAO/RCED-89-9; Feb. 14, 1989)

As requested by Senator Jesse Helms, Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry at the time of his request, this report determines (1) whether the criteria FmHA uses to make and service loans are adequate, (2) how borrower equity positions (net worth) are affected by FmHA loan-making policies, (3) whether security for FmHA loans is adequate, and (4) what impact more stringent loan-making criteria proposed by FmHA in January 1987 would have on existing borrowers. The message of this report is discussed in the overall testimony.

Farmers Home Administration: Status of Participation in the Interest Rate Reduction Program (GAO/RCED-89-126BR; June 15, 1989)

This report is addressed to Representative Leon Panetta and provides information on (1) the extent of use of the interest rate reduction program for guaranteed farm loans, (2) reasons why activity is at its present level and the likelihood of expansion, (3) the potential impact of FmHA-guaranteed farm loans with interest rate reduction on the U.S. budget compared with that of FmHA direct loans, and (4) compliance issues identified by USDA's Office of Inspector General.

Farmers Home Administration: Implementation Issues Concerning Four Sections of the Food Security Act (GAO/RCED-89-71; June 19, 1989)

This report is addressed to the Chairman, House Committee on Agriculture, and provides information on four provisions of the Food Security Act of 1985 designed to help financially distressed farmers with FmHA farm loans: (1) homestead protection, (2) disposition and leasing of farmland commonly referred to as "lease/buy-back," (3) conservation easement, and (4) softwood timber production. The report discusses the extent of program use and whether the provisions were modified by the Agricultural Credit Act of 1987 and identifies several issues the Congress and the Secretary of Agriculture should consider in assessing how the provisions are being implemented.

For example, borrowers could use the same land to benefit from both (1) the conservation reserve program administered by the Agricultural Stabilization and Conservation Service and the conservation easement provision and (2) the conservation reserve program and the softwood timber provision. Our work also showed that FmHA charged interest rates for softwood timber loans, which were generally lower than the maximum permitted by the 1985 act, and calculated interest on a simple, rather than compound, interest basis. As a result, we calculated that at the end of the deferral period the government would receive about $21.4 million less in interest revenues for the 14 approved softwood timber loans (the total number of loans approved at the time of our review) than it would otherwise receive. To illustrate the significance of the potential reduction in interest revenues for the maximum number of acres that can be included in FmHA's softwood timber program, we calculated that the government--under certain assumptions--would receive over $1 billion less in interest revenues than it would otherwise receive at the end of the deferral period if all allowable acreage (50,000 acres) was to be enrolled in the program.

Information Management: Issues Important to Farmers Home Administration Systems Modernization (GAO/IMTEC-89-64; Aug. 21, 1989)

This report is addressed to the Acting Administrator, Farmers Home Administration, and provides information on FmHA's planning efforts to redesign, replace, or enhance its automated systems at an estimated cost of at least $100 million over the next 5 to 7 years. The report discusses several issues that are critical to the success of FmHA's moderization plans. Those issues include (1) ensuring that the modernization program addresses the information needs of all agency components, (2) ensuring that the agency has a sufficient number of qualified managers and staff to support its continuing day-to-day operations and to implement the modernization program, (3) developing and following instructions for preparing complete economic analyses to help ensure cost-effective modernization decisions, and (4) providing for a strong data-administration function to develop and ensure compliance with standards, so that individual systems can easily share information.

Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86; Sept. 11, 1989)

This report is addressed to the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, and provides information on FmHA's progress in shifting from direct to guaranteed farm loans and the financial condition of the guaranteed loan borrowers; the impact of this shift on borrowers, private lenders, and the government; and program problems that contributed to losses on guaranteed loans. The message of this report is discussed in the overall testimony.

Farmers Home Administration: Loan Servicing Benefits for Bad Faith Borrowers (GAO/RCED-90-77FS; Nov. 29, 1989)

This report is addressed to the Chairman, Subcommittee on Agricultural Credit, Senate Committee on Agriculture, Nutrition, and Forestry, and provides examples of FmHA delinquent borrowers who have acted in bad faith and who have received benefits, or will be eligible to receive benefits, under the provisions of the Agricultural Credit Act of 1987. The message of this report is discussed in the overall testimony.

Financial Audit: Farmers Home Administration's Financial Statements for 1988 and 1987 (GAO/AFMD-90-37; Jan. 25, 1990)

This report is addressed to the Secretary of Agriculture and presents the results of our examination of FmHA's financial statements for the year ending September 30, 1988, and our reports on internal accounting controls and compliance with laws and regulations. The message of this report is discussed in the overall testimony.

Farmers Home Administration: Use of Loan Funds by Farmer Program Borrowers (GAO/RCED-90-95BR; Feb. 8, 1990)

This report is addressed to the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, and provides information on the use of four major types of farmer program loans during fiscal year 1988 (direct farm ownership loans, direct farm operating loans, guaranteed farm ownership loans, and guaranteed farm operating loans), the extent to which loan funds were used to refinance farmers' existing debts, and lenders' views on using FmHA loan guarantees. The message of this report is discussed in the overall testimony.

CASE STUDIES OF GUARANTEED FARM LOAN PROGRAM BORROWERS WHO HAD DEFAULTED ON THEIR LOANS

In our report entitled Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86; Sept. 11, 1989) we provide three case studies on borrowers who had defaulted on FmHA-guaranteed loans to illustrate many of the problems we identified. The three case studies from that report follow.

Case Study A

A borrower received an operating loan in April 1986 for about $118,000, which FmHA guaranteed at 90 percent. This loan was for production purposes and to make payments to other creditors for the borrower's son. The borrower listed no debts and total assets of $215,000. The assets consisted of $10,000 in cash, $145,000 in savings, and $60,000 in real estate. It appeared that the borrower had sufficient collateral to obtain a loan without the FmHA guarantee. However, the guaranteed loan was secured only by a crop lien and assignment of ASCS payments on 600 acres of cotton and soybeans. The borrower had no crop insurance and leased land from his son for farming purposes.

The county supervisor indicated on the guaranteed loan evaluation form that the security offered (crops) appeared adequate and that the borrower had been unable to obtain necessary credit without a guarantee. The county supervisor's evaluation of the borrower's inability to obtain credit without a loan guarantee appeared questionable because (1) a letter from the private lender accompanying the loan application did not state that credit would be denied without the guarantee and (2) the borrower had not signed the Conditional Commitment for Guarantee certifying that credit was not available at reasonable rates and terms.

The borrower's repayment estimate showed projected income from crop production of $112,750, government payments of $19,000, and other income of $5,900 for a total projected income of $137,650. Loan records showed the borrower was actually loaned $106,200 of the $118,000 approved and repaid only $72,781. Of this amount, $64,600 was applied to loan principal and $8,181 was for interest on the loan. In March 1987 the lender filed a loss claim with FmHA for $42,286, and in May 1987 FmHA paid the lender $38,409, including accrued interest until date of payment, to honor its 90-percent guarantee.

We identified several problems with this guaranteed loan. First, the loan guarantee request probably should not have been approved because sufficient assets, including cash and savings, were available to finance the farming operation without a loan guarantee. Second, one of the loan's purposes--payment of the borrower's son's debts--is not a permissible loan purpose under FmHA's regulations. Third, accepting crops as the only collateral without crop insurance and when over $200,000 in unencumbered security was available proved to be a costly mistake because FmHA paid the lender a loss claim of over $38,000. Finally, until our inquiry there was no evidence that either FmHA or the lender pursued recovery of this $38,000 from the borrower despite the apparent existence of ample assets on which to base a recovery.

Case Study B

In April and May 1985 a lender obtained two guaranteed loans for an existing borrower, a 1-year operating loan for $95,000 and a farm ownership loan for $275,000. The operating loan, secured by 1985 crops and guaranteed at 50 percent, was to be used for rent, crop production expenses, and the purchase of feeder pigs. The farm ownership loan, guaranteed at 90 percent, was to cover refinancing of past operating losses and capital expenditures. The farm ownership loan was secured by a third lien position on 400 acres of land and machinery. The lender agreed to write off $30,000 of the borrower's debt to help ensure survival and obtain the farm ownership loan guarantee. The farm ownership loan guarantee was approved by the FmHA state office because the loan amount exceeded the county supervisor's approval authority.

In September 1985 the lender sold the farm ownership loan on the secondary market. By January 1986 the borrower was in default on both loans, and the lender gave FmHA notice of default and proposed liquidation action. FmHA approved the liquidation of the loan accounts in April 1986. In June 1986 the lender advised FmHA that other lenders had claims of $778,000 against the 400 acres of land and that it was unlikely there would be any equity to protect on their lien. The lender obtained sufficient funds from the borrower to pay the balance due on the operating loan but filed a loss claim for the outstanding balance of $234,290 on the guaranteed farm ownership loan. The guaranteed loss amount was $210,861.

In reviewing the case file, the county supervisor found several problems that resulted in a recommendation against loss payment because of lender misrepresentation. Among these problems were the following:

-- The borrower made a major change in his farming operation between the time of loan application and loan closing that was not reported to FmHA, nor was revised financial data submitted to reflect the new operation.

-- An after-the-fact June 1986 lender submission of financial information on the revised farm operation, according to the county supervisor, overstated the projected income and the farmer's capacity to operate at the level indicated.

-- The lender omitted from the loan application a Federal Land Bank debt of $51,000 against the land, resulting in significantly overstating the collateral available to secure the third lien position on the farm ownership loan guarantee.

-- The land value shown in the borrower's January 1985 financial statement was significantly higher than that shown just prior to the liquidation decision in December 1985 ($936,600 versus $550,000), causing the county supervisor to question the reliability of the lender's appraisal submitted with the loan guarantee request.

In countering the county supervisor's recommendation, the lender maintained that the change in operation had been discussed with an FmHA state official, and this state official said that no new cash flow projection or amendment to the application was needed. The state official, however, could not recall such a conversation. The county supervisor maintained that, had he been informed of the change in operation and aware of the additional $51,000 lien against the farm, the loan guarantee request may have been denied.

The dispute over the loss claim continued for about 2 years during which time interest continued to accrue on the outstanding balance of the farm ownership loan. Another complicating factor was that the farm ownership loan note had been sold in the secondary market, and the holder was demanding the payments that the lender was supposed to collect and forward under the servicing agreement. On June 23, 1987, the lender acting on behalf of FmHA notified the holder to surrender to FmHA the guaranteed part of the loan and advised the holder to contact the FmHA county office to arrange for loss payment. On June 25, 1987, the holder demanded that the lender repurchase the unpaid guaranteed portion of the loan. The lender refused this request and again advised the holder to demand payment of the guarantee from FmHA.

According to a state official, FmHA submitted the required paperwork for payment of a loss claim of about $245,200 on May 13, 1988. However, at the time of our review, FmHA apparently still had a dispute with the lender over $6,000 that it believed the lender should pay FmHA. On June 2, 1988, FmHA finally paid the holder $247,735 to settle the loss claim.

This case study illustrates several program problems, including questionable loan approval, possible misrepresentation, questionable collection efforts, and an untimely loan loss payment. The questionable loan approval and other subsequent events resulted in a loss to FmHA of over $200,000, and, in not settling this loss claim promptly, FmHA incurred additional losses of about $40,000 because of interest accrual.

Case Study C

This borrower received two operating loans that FmHA guaranteed at 90 percent in May and June 1986--a $267,580 line of credit for production expenses and a $78,900 loan note guarantee to refinance three pieces of equipment. The line of credit was secured by a crop lien on soybeans, milo, and cotton to be planted on 2,756 acres. The loan note was secured by five pieces of equipment, which had an estimated value of $63,600 according to the borrower's financial statement. The maturity date on the line of credit was December 1, 1986.

The borrower's financial statement showed total assets of $335,200 and total liabilities of $754,667, for a negative net worth of $419,467. At the time of loan application, the borrower had nine outstanding direct loans from FmHA with a total loan amount of about $345,000. Four of the loans were delinquent but were rescheduled and brought current in order to approve the loan guarantees.

In August 1987 the lender requested in a letter to the county supervisor that FmHA pay its 90-percent guarantee on the line-of-credit production loan. The lender advised FmHA that the borrower had paid a total of $208,423 of the $267,272 advanced under the line of credit, but the lender had advanced the borrower an additional $12,674 to cover certain harvesting expenses, resulting in a principal balance shown by FmHA of $71,431 (although the net amount would appear to be $71,523). With accrued interest on the outstanding principal remaining, the amount of loss claim on the line of credit was $74,090, and FmHA paid the lender $66,681 to honor the guarantee.

From the borrower's loan file, the lender's letters to FmHA, and discussions with the loan officer and FmHA officials, we identified the following problems with this case.

- The loan file contained no county committee certification of loan eligibility and no loan evaluation form.

- -- The borrower was technically insolvent with a negative net worth of over $400,000 and had a series of FmHA direct loans, some of which required rescheduling prior to approval of the loan guarantees, indicating that approving an operating loan guarantee with crops as the only security at 90 percent was highly risky.

- -- The lender released $12,674 of crop proceeds to the borrower to cover certain harvesting expenses without obtaining the required FmHA approval for making the advance and, contrary to FmHA regulations, included this advance in the loss claim. FmHA included the advance in settlement of the loss claim, which resulted in FmHA's paying a loss that exceeded 90 percent of the unpaid balance of the loan.

- -- The lender did not provide FmHA a notice of default or a liquidation plan prior to submitting a loss claim about 8 months after the maturity date of the line-of-credit guarantee.

According to the lender and FmHA officials, the borrower continued to farm in 1987 despite the liquidation of the line-of-credit guarantee and FmHA's payment of a loss claim to the lender. The borrower still experienced financial problems, however, as demonstrated by the fact the he made no payments on his FmHA direct loans or on the guaranteed portion of the line-of-credit loan. In view of the borrower's past and continuing financial problems, we asked FmHA state officials of their rationale for guaranteeing loans at 90 percent to this borrower. Their response follows.

> "Our policy is to allow the maximum guarantee in cases involving financial statements such as that produced by the borrower provided the security value and repayment ability are realistically projected as adequate. Cases in this category are often salvable and lenders would not make loans to this type client without a guarantee as additional security. However, in cases projecting more than adequate security and other unencumbered assets with very marginal repayment ability, our policy is to grant less than a maximum guarantee because the lender's exposure is less and the government's protection from losses are needed to a much lesser degree."

This case study illustrates how loan losses can result from inadequate (1) evaluation of a borrower's financial condition prior to approving a loan guarantee request, particularly the assessment of collateral backing the loan and the determination of the percentage of guarantee and (2) monitoring of a lender's servicing activities, particularly approving lender advances to borrowers and requiring proper and timely submission of default notices and liquidation plans.

EXAMPLES OF FmHA BAD FAITH BORROWERS WHO HAVE RECEIVED BENEFITS, OR WILL BE ELIGIBLE TO RECEIVE BENEFITS, UNDER PROVISIONS OF THE AGRICULTURAL CREDIT ACT

In our report entitled Farmers Home Administration: Loan Servicing Benefits for Bad Faith Borrowers (GAO/RCED-90-77FS; Nov. 29, 1989) we identified several case examples in one FmHA county office of bad faith borrowers[1] who had benefited, or will be eligible to receive benefits, under provisions of the Agricultural Credit Act. The examples, which demonstrate the reasons for FmHA bad faith determinations and the benefits available to bad faith borrowers, are based on a review of delinquent borrowers' files and discussions with the FmHA county supervisor. The examples were developed during our ongoing debt restructuring work for the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry. These examples do not include all bad faith, or potential bad faith, borrowers who came to our attention during our review. For example, the FmHA county supervisor in another office identified 11 borrowers who may have acted in bad faith, but he did not pursue a formal bad faith opinion from the USDA Office of General Counsel to deny their restructuring request since they qualified for net recovery value buyout and not for restructuring.

BACKGROUND

The Agricultural Credit Act of 1987 directed FmHA to modify the debts of its borrowers who were 180 days or more delinquent through the use of a series of primary loan servicing, or restructuring, options so that loan losses on farmer program loans are avoided and borrowers are able to continue farming or ranching operations. The restructuring options include loan consolidation, rescheduling, or reamortization; interest rate reduction; deferral, set aside, or write down of outstanding principal and accumulated interest; or any combination of these actions. The act contains various conditions that delinquent borrowers must meet to qualify for restructuring.

Borrowers who do not qualify for restructuring are eligible to buy out of their FmHA debt. The buyout amount is based on an adjusted value of the collateral that secures their debt and is referred to as the net recovery value.

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[1] We use the phrases "borrowers who act in bad faith" and "bad faith borrowers" to refer to those FmHA delinquent borrowers whose delinquency was due to circumstances within their control or who did not act in good faith in connection with the terms of their FmHA loans.

In addition, borrowers who are not restructured, and those who do not buy out of their debt at the net recovery value, are subject to foreclosure by FmHA on the collateral securing their loans. The Agricultural Credit Act and the Food Security Act of 1985 provide preservation loan servicing options to borrowers whose real property is foreclosed. These options are the right to purchase or lease the farmland back from FmHA and the right to purchase their farm homestead. FmHA delinquent borrowers who act in bad faith are eligible for net recovery value buyout consideration as well as preservation benefits when they do not buy out of their debt and FmHA forecloses on the real estate property securing their FmHA loans.

BORROWERS RECEIVING NET RECOVERY VALUE BUYOUT BENEFIT

Example A. The FmHA county office determined that this borrower was ineligible for loan restructuring because he did not act in good faith in connection with his loan agreements. The county office supervisor told us the borrower sold some farm equipment that was FmHA security property. Also, the borrower subsequently had another family member, who is also an FmHA borrower, sell some additional farm equipment. In addition, a regional attorney in USDA's Office of General Counsel wrote that the borrower had converted numerous items of FmHA security property. The sales of properties were made without county office approval. None of the proceeds from the sales were applied to the borrower's FmHA debt.

The borrower appealed the county office's decision. The appeals hearing officer decided that while the borrower was ineligible for restructuring, he was eligible for net recovery value buyout since the net recovery value exceeded the present value of the restructured loans when the county office ran the debt restructuring software program--Debt and Loan Restructuring System (referred to by FmHA as DALR$). At the time of our review, the borrower had not responded to the county office's net recovery value buyout offer.

According to the DALR$ printout, this borrower owed FmHA $625,952 in outstanding principal and unpaid interest. The debt covered six natural disaster emergency loans and two operating loans, valued at a total of $602,560 and $23,392, respectively. The net recovery value was $87,277. In addition, the appeals hearing officer wrote that the borrower is also required to pay FmHA $30,000 for the value of other property not accounted for in the appraisal of the loan security. The total buyout amount, which covers real estate and chattels, is $117,277. The borrower will receive a $508,675 write-off if he pays the buyout amount.

In addition, this borrower will be eligible for preservation benefits if he does not pay the buyout amount and FmHA forecloses on his property. For example, the market value of his 311-acre farm, which could be acquired through the leaseback/buyback option, is $44,000.

Example B. The FmHA county office determined that this borrower was ineligible for loan restructuring because he did not act in good faith in connection with his loan agreements. The county office supervisor told us the borrower sold equipment that was FmHA security property. In addition, a regional attorney in USDA's Office of General Counsel wrote that the borrower had converted FmHA security property he owned and other property that was pledged as security for FmHA loans by another member of his family. The sales of properties were made without county office approval. None of the proceeds from the sales were applied to the borrower's FmHA debt.

The borrower appealed the county office's decision. The appeals hearing officer decided that while the borrower was ineligible for restructuring, he was eligible for net recovery value buyout since the net recovery value exceeded the present value of the restructured loans when the county office ran the DALR$ program. At the time of our review, the borrower had not responded to the county office's net recovery value buyout offer.

According to the DALR$ printout, this borrower owed FmHA $249,811 in outstanding principal and unpaid interest. The debt covered two operating loans (totaling $110,189), one natural disaster emergency loan ($81,580), one rural housing loan ($34,872), and one farm ownership loan ($23,170). The net recovery value, which covers real estate and chattels, was $164,353. The borrower will receive an $85,458 write-off if he pays the buyout amount.

In addition, this borrower will be eligible for preservation benefits if he does not pay the buyout amount and FmHA forecloses on his property. For example, the market value of his 636-acre farm, which could be acquired through the leaseback/buyback option, is $153,000.

Example C. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us the borrower had previously applied to FmHA for loans to buy additional land and equipment. The county office did not approve the applications and advised the borrower that the equipment was excessive to his needs. For example, the county office determined that the equipment purchases resulted in the borrower having $268 per acre worth of equipment, while the state average was $50 per acre. Subsequently, the borrower made the purchases with loans from other lenders. The borrower repaid the other lenders, including making advance principal payments; however, he became delinquent on his FmHA debt.

The borrower appealed the county office's decision. The appeals hearing officer decided that while the borrower was ineligible for restructuring because of his excessive machinery purchases, he was eligible for net recovery value buyout since he did not have a feasible plan of operations, including a positive cash flow, and the net recovery value exceeded the present value of the restructured loans when the county office ran the DALR$ program. At the time of our review, the borrower had not responded to the county office's net recovery value buyout offer.

According to the DALR$ printout, this borrower owed FmHA $186,616 in outstanding principal and unpaid interest. The debt covered four natural disaster emergency loans and two farm ownership loans, valued at a total of $117,716 and $68,900, respectively. The net recovery value, which covers real estate, was $134,815. The borrower will receive a $51,801 write-off if he pays the buyout amount.

This borrower will be eligible for preservation benefits if he does not pay the buyout amount and FmHA forecloses on his property. However, it will be to his advantage to pay the buyout amount if he wants to keep his farm because the market value of his real estate exceeds his outstanding FmHA debt. He would have to pay the amount of his outstanding debt to exercise the leaseback/buyback option since the market value of his 1,174-acre farm is $188,000.

Example D. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. According to information in the county office records, in 1985 the borrower abandoned the property that had been pledged as security for the FmHA loans, made no effort to maintain the property, and became delinquent on his FmHA debt.

The county office determined that this borrower was eligible for net recovery value buyout since he did not have a feasible plan of operations, including a positive cash flow, and the net recovery value exceeded the present value of the restructured loans. At the time of our review, the borrower had not responded to the county office's net recovery value buyout offer.

According to the DALR$ printout, this borrower owed FmHA $151,605 in outstanding principal and unpaid interest. The debt covered one farm ownership loan and one natural disaster emergency loan, valued at $146,458 and $5,147, respectively. The net recovery value, which covers real estate, was $12,515. The borrower will receive a $139,090 write-off if he pays the buyout amount.

This borrower will be eligible for preservation benefits if he does not pay the buyout amount and FmHA forecloses on his property. However, it will be to his advantage to pay the buyout amount if he wants to keep his farm because the net recovery value buyout amount is less than the $23,000 market value of his 147-acre farm.

BORROWERS RECEIVING PRESERVATION BENEFIT

Example E. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us this borrower's application for restructuring showed he had resources available that could have been used to make his FmHA loan payments. According to information in the county office records, the borrower had $83,400 in available income and other assets that were not essential to his farming operation, such as recreational vehicles, while his delinquency was $43,106.

The county office determined that this borrower was not eligible for net recovery value buyout since the DALR$ program showed he would have had a feasible plan of operations with restructuring, including a positive cash flow. The borrower would have been offered restructuring if he had not caused the delinquency. At the time of our review, the borrower had appealed the county office's decision; an appeal decision had not been made.

According to the DALR$ printout, this borrower owed FmHA $279,890 in outstanding principal and unpaid interest. The debt covered three natural disaster emergency loans. He will be eligible for preservation benefits if FmHA forecloses on his property. The market value of his 1,840-acre farm, which he could reacquire through the leaseback/buyback option, is $201,000.

Example F. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us this borrower rents his farm to his son and claims that the son has not made any rental payments. However, the borrower's restructuring application shows rental income and the county office has documented that the borrower has been current on payments to other creditors, including advance principal reduction payments.

The county office determined that this borrower was not eligible for net recovery value buyout since the DALR$ program showed he would have had a feasible plan of operations with restructuring, including a positive cash flow. The borrower would have been offered restructuring if he had not caused the delinquency. At the time of our review, the borrower had appealed the county office's decision; an appeal decision had not been made.

According to the DALR$ printout, this borrower owed FmHA $650,185 in outstanding principal and unpaid interest. The debt covered three natural disaster emergency loans. He will be eligible for preservation benefits if FmHA forecloses on his property. The market value of his 3,140-acre farm, which he could reacquire through the leaseback/buyback option, is $470,000. A prior lien in the amount of $224,906 exists on the borrower's farm real estate.

Example G. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us this borrower had resources available that could have been applied to his delinquent debt and that he had paid other lenders more than his loan agreements with them required him to pay. Specifically, documentation in the county office files showed the borrower had $66,400 in income that he could have applied, but did not apply, to his FmHA debt. Also, the borrower repaid two other lenders, including advanced principal payments to both, and became delinquent on his FmHA loans. For example, he repaid the two commercial lenders a total of $74,907; his loans called for payments totaling $24,320.

The county office determined that this borrower was not eligible for net recovery value buyout since the DALR$ program showed he would have had a feasible plan of operations with restructuring, including a positive cash flow. The borrower would have been offered restructuring if he had not caused the delinquency. At the time of our review, the borrower had not appealed the county office's decision.

According to the DALR$ printout, this borrower owed FmHA $371,604 in outstanding principal and unpaid interest. The debt covered two natural disaster emergency loans and one operating loan, valued at a total of $149,723 and $221,881, respectively. He will be eligible for preservation benefits if FmHA forecloses on his property. The market value of his 1,480-acre farm, which he could reacquire through the leaseback/buyback option, is $207,000. A prior lien in the amount of $82,246 exists on the borrower's farm real estate.

Example H. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us this borrower's application for restructuring showed that he had resources available that could have been used to pay his delinquent amount. Specifically, documentation the borrower submitted to the county office showed he had $91,284 in his checking account when he applied for restructuring; he was $76,269 past due on his scheduled FmHA payments. Also, the borrower may have converted some FmHA security property. A letter in the county office files states that the borrower sold cattle, which was security for an FmHA loan, without county office approval and did not pay any of the sales proceeds to FmHA.

The county office determined that this borrower was not eligible for net recovery value buyout since the DALR$ program showed he would have had a feasible plan of operations with restructuring, including a positive cash flow. The borrower would have been offered restructuring if he had not caused the delinquency. The borrower appealed the county office's decision; an appeals officer upheld the county office's decision.

According to the DALR$ printout, this borrower owed FmHA $348,223 in outstanding principal and unpaid interest. The debt covered two farm ownership loans (totaling $69,631), one operating loan ($242,742), and one natural disaster emergency loan ($35,850). He will be eligible for preservation benefits if FmHA forecloses on his property. The market value of his 1,163-acre farm, which he could reacquire through the leaseback/buyback option, is $151,000. A prior lien in the amount of $9,000 exists on the borrower's farm real estate.

Senator **Conrad**. Very well. I want to thank you very much for the work that you have done. It is of great assistance to the committee, the Congress, and to the agency as well. And I see Sox nodding in agreement. Obviously, we all want this agency to work efficiently and well, and it is very important for us to understand the financial implications of what is occurring in order to make those improvements that are necessary. So we thank you for the rather extraordinary effort that has been made here by all of you to produce this report and the others that you have done. They certainly are first-class, very professional, and we appreciate the effort.

Mr. **Harman**. Thank you.

Senator **Conrad**. Let me ask you in looking at the financial losses of the agency, how much are you able to attribute to the rather severe economic decline that agriculture suffered in this period? Looking at the period of the late 1970's through the current period, in terms of substantial losses being suffered during that time, how much do you attribute to the collapse of commodity values, and the tremendous dropoff in farm asset values with the drop in land prices?

Mr. **Harman**. Well, certainly a large portion of what Farmers Home has experienced in terms of losses has to be attributed to the downturn in the farm economy during the 1980's. Dennis, can maybe speak to this in a little more detail, but I do not think we have broken that out to try to determine how much was before and how much was after. But if you just look at the amount of delinquencies they had pre-1978 or so and what they have experienced since that time, I would think that a large portion of the losses would have to occur during the 1980's, in the late 1970's.

Mr. **Duquette**. I would agree with that.

Senator **Conrad**. Would you just identify yourself, again, for the record to assist our transcriber?

Mr. **Duquette**. Dennis Duquette.

Senator **Conrad**. Yes.

Mr. **Duquette**. It is D-U-Q-U-E-T-T-E.

Senator **Conrad**. Italian name.

Mr. **Duquette**. Italian. I definitely would agree that most of the losses occurred since the late 1970's, and I concur that we have not attempted to break those out separately. I am not even sure that the records are available to do that to be quite honest with you.

Senator **Conrad**. But would it be safe to assume that a substantial part of these losses have occurred at the same time we saw this severe downturn in the farm economy?

Mr. **Duquette**. I am very comfortable with that assumption.

Senator **Conrad**. And would it be also safe to assume and to assert that a significant majority of these losses attend to the two emergency programs, the Economic Emergency and the Emergency Disaster Programs that have now been terminated or sharply curtailed by Congress?

Mr. **Duquette**. I think that is true, and if you want I will draw your attention to Note 5 to the financial statements, which sets that out for fiscal year 1988. For example, for the ACIF——

Senator **Conrad**. This is what we had talked about earlier?

Mr. **Duquette**. This is exactly what we talked about earlier, and this is the recently issued set of financial statements on Farmers Home which includes our opinion, and on page 28, as I mentioned, in Note 5, you will see a breakout by program. For the ACIF fund, the unpaid principal is about $25.5 billion. The allowance, as of the end of fiscal year 1988, is $14.5 billion, with a net unpaid principal of about $11 billion. And if you look at the two specific programs that you mentioned, the Emergency and Economic Emergency, which amount to about $9 billion of the total allowance of $14.5 billion, surely they represent the major share.

Senator **Conrad**. The lion's share is in those two programs—65 percent is in those programs. Correct me if I am wrong, but I believe one of those was eliminated in 1984 and the other sharply curtailed as part of the 1985 Farm Act. Maybe, Sox, you can help us with that. Or Mr. Harman.

Mr. **Harman**. That was correct. The Economic Emergency Assistance loans were eliminated in about September of 1984.

Senator **Conrad**. September of 1984.

Mr. **Harman**. And the Emergency Disaster Assistance loans have been curtailed.

Senator **Conrad**. Sox, would you want to comment on that statement?

Mr. **Johnson**. I believe they started that with the farm bill in 1980. I believe that is where this came into play.

Mr. **Duquette**. That is correct.

Mr. **Johnson**. It started, and it was set over, as I recall, a 3 year period of time in which we were to scale back on the size, maximum size of loans and so forth. I believe that is correct.

Senator **Conrad**. All right. Thank you very much. Thank you for that as well.

Let me go to another set of issues. Mr. Harman, on pages 6 and 7 of your prepared testimony [see pp. 64–65], and I am glad, Sox, that you are still able to be with us because I did not have a chance to talk to you about this. But I do think we want to raise this issue. I'm quoting from your testimony.

> In our latest report on FmHA's system of internal accounting controls, we noted material weaknesses in the loan classification system used to estimate losses on individual farm loans. Changes are needed to correct these weaknesses so that future loss provisions are properly estimated.

You then go on to indicate:

> Furthermore, our report discloses the following material internal accounting control weaknesses related to acquired property: * * *

And you list three there.

Would you want to comment on that, John, and then, Sox, we might want to get a comment from you for the record in terms of FmHA's plans for dealing with the outlined weaknesses? What the plan is for correction? John, if you would?

Mr. **Harman**. I will pass that right along to Dennis and let him comment on it.

Senator **Conrad**. OK.

Mr. **Duquette**. Let us take the loan classification system first. We found a problem in that the records did not provide the information necessary to determine potential loan losses. For purposes of this report, in order to render our opinion on the financial statements, we did a considerable amount of work. But the system that provides detail loan loss information on acquired property is not quite there yet. So we had a concern about that, and of course, it was a basis for qualification of the financial statements.

The acquired property, though, if I can just direct your attention to—I will be very quick here—to page 19, which is the statement of financial position, you will see that acquired property for fiscal year 1988 is reported at about $900 million. So in the grand scheme of things, it is not terribly great. But the recordkeeping was sufficiently poor that we were unable to determine its accuracy.

Senator CONRAD. All right. Mr. Harman let me just indicate further, in your prepared testimony [see p. 65]:

> While FmHA has made progress in improving the financial management of its operations, there remain several areas of concern. The agency's financial management systems do not provide the kind of cost information that program managers need to effectively evaluate the results of their decisions. There is also a need for more effective accountability reporting. The preparation and audit of annual financial statements is now in its third year.

And you go on to indicate you "strongly recommend the continuance of this practice."

Sox, maybe it would be appropriate at this point to have you comment if it is the intention of the agency to continue with the preparation and the audit of the financial statements, and what is intended to be done to meet the shortcomings that are described in the GAO report?

Mr. JOHNSON. We certainly are very much interested in going over these in more detail. Obviously, we just got this report not long ago. I have had one brief exit conference with them so we want to be sure we understand we are talking about the same thing. There is no question in our mind we need a lot better financial information. We need a lot better automated financial information. And so we have a lot of programs that we are working on to improve the management of these operations through that.

As it relates to the acquired property, of course, as you know, we anticipate increasing substantially in the number of acquired properties as a result of the efforts we are taking with the Agricultural Credit Act of 1987 as we work through these cases. So we see a lot of them. We are already now having all of our States to do individual survey and appraisal of that property so we can determine now what is the value of that property regardless of what was owed on it and so forth to make necessary adjustments for those types of figures.

So I guess I cannot be more specific than that, other than to say we are very much interested. We recognize because we have identified many, many management initiatives that we need of our own to have better information, more timely information, and certainly we are looking at these as positive suggestions in helping us identify those other needs, and we want to look at them. We may quibble with them over some points later, but generally we are taking a very positive attitude about the type of information we are getting here.

Senator CONRAD. Let me ask you this. Is it your intention, and is it the commitment of the agency to continue with the preparation and audit of annual financial statements? We have had that for 3 years apparently, according to the GAO report. Is it the commitment of the agency that we would continue with that?

Mr. JOHNSON. I do not know of any reason why we would not. We should want to know it. Obviously we are going to all have to learn the terminology and everything, and hopefully as time goes on. I know I have not had nearly as much trouble this year dealing with the $42 billion as I had a year ago dealing with the $36 billion over some of the things we talked about earlier. But again I think it is important that we do it and we would fully expect to do it.

Senator CONRAD. All right. And there is a commitment, a good faith commitment on the part of the agency—do not let me put words in your mouth—that those weaknesses in terms of internal management, accounting controls, and other problems that have been described by GAO, will be corrected by the agency?

Mr. JOHNSON. Yes, I would say that is true. Let me say as far as an accounting system, I think Farmers Home has an accurate, good accounting system on individual accounts and so forth. I am not as concerned about that. We do not have the type of management information and be able to extract that in management information in the manner we would like to. So our management information letter is more difficult and cumbersome, and that is the reason we have to go back and do a lot of surveys and so forth.

But I personally feel and from all the indications I have had from the staff that our accounting system is OK as such and is accurate as such on individual cases and how we deal with individual cases. We do not always get all the information we would like to have, and I think it is more of a management information problem than an accounting problem, as I see it.

Senator CONRAD. John or any of the others? Dennis, perhaps, you would want to comment on that?

Mr. DUQUETTE. I think I would agree in total. I think we would have some problems with the ability to pull together critical financial information, certainly at the lower level for decisionmaking, and certainly in pulling together financial statements at the top level. So the idea of having a good general ledger system that ties everything together and enables you to put together a set of financial statements for external reporting, we are not quite there yet. And that also means in reconciling with the Treasury reporting, the 220's, 221's, et al. But Mr. Chairman, I must say that FmHA is no worse off than most other agencies that we look at.

Our present Comptroller General is very concerned about this problem, which is very pervasive in that the financial management systems are not in place at many agencies. The agency managements are not, in effect, discharging their fiduciary responsibilities by reporting good solid financial information, that hopefully is attested to through an independent audit. And that is something we, at GAO, have been pushing very hard.

Senator CONRAD. Well, let me just say as a former tax commissioner and somebody who puts a great deal of stock in having accurate information and accounting systems that allow you to make appropriate judgments, I have been absolutely appalled at what I see of government accounting systems. They need improvement.

The Comptroller General has been precisely right in his emphasis in getting management information upon which to base judgment.

So I share that commitment, and I want to make certain that each of the agencies over which we have oversight authority take this seriously. I take it from your comments, Sox, that you do. At a future time I think we will want to talk about the management initiatives that are being taken to implement the recommendations that we get in these annual reports. I think that will be important to do. Obviously you need some time to evaluate what it is that is being said and put in place appropriate plans. But I think we will want to talk about that at a future date.

And again, I know that you have other obligations, but I very much appreciate your staying for the purposes of this conversation.

Mr. HARMAN. I would like to add, Mr. Chairman, too, the responsiveness that we have gotten from Farmers Home has been excellent in terms of all the work we have done, and I would like to thank Sox for that.

Mr. JOHNSON. Thank you.

Senator CONRAD. All right. One other thing that I would be remiss if I did not ask you is that your report on the financial condition of FmHA shows substantial delinquencies.[5] Is it not true that the data entry process for FmHA and their financial information system has lagged substantially behind the restructuring process so the hard reality is we do not have current information to judge the current condition of the agency's portfolio?

Mr. HARMAN. That is absolutely correct. We are lagging behind. The portfolio has been decreasing to some extent. It will probably decrease more as a result of the Agricultural Credit Act initiatives. I might ask that Pat Sweeney who has done some detailed work on that, if he would like to comment for any details to go ahead.

Mr. SWEENEY. Mr. Chairman, that is exactly correct. As the agency goes through the Agricultural Credit Act servicing process, restructuring with write-down, the borrowers who are going through the net recovery buyout provision, and those who eventually will go through the preservation, will result in the portfolio being, the outstanding amount decreasing substantially, and also the delinquency amount will go down.

Senator CONRAD. Is it fair to say that the delinquency rate will go down substantially when that data is entered?

Mr. SWEENEY. That is correct.

Senator CONRAD. So that is some good news here. I think we need to find some good news in all of this, and that is certainly good news. When will we know about that?

Mr. SWEENEY. You will not know about that for about another year or so.

Senator CONRAD. Another year.

Mr. SWEENEY. Until the agency completes processing the enormous go-around. The first go-around there were 65,000 borrowers notified.

Senator CONRAD. Yes.

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[5] Farm Finance, Financial Condition of American Agriculture as of December 31, 1988, GAO/RCED-90-49BR, GAO, November 1989.

Mr. SWEENEY. The second go-around had another 10,000 notified. Until they work through all of those applications, the numbers will not reflect the servicing that is going to take place.

Senator CONRAD. Well, that confirms a point I wanted to make, and that is simply that in some sense we are shooting at a moving target here. We had a farm depression in the 1980's. We had some very loose lending practices that were out there regarding these emergency loan programs that have either been terminated or sharply curtailed. We had the Agricultural Credit Act of 1987 to clean up some of these problems, and we have not yet seen the positive results of that act in terms of the numbers we are looking at.

There is nothing we can do about that except to be able to call on you gentlemen who are able to give us your own impressions, people who have worked most closely with it, and that is very useful to us.

Mr. HARMAN. One thing that we also will be able to show as a result of the work that we are doing for Chairman Leahy will be the condition of some of these borrowers after they are restructured as a result of the Agricultural Credit Act. So we will get some idea. What we are concerned about with all of this is we do not get back into the cycle that we have been in over the last 8 or 10 years, and part of that will involve some tightening of the credit standards. Perhaps not to keep people from getting loans, but at least to know what kind of condition these people are in so they can give them the kind of financial management and education and instruction that they need. And we feel strongly that we need that kind of information.

Senator CONRAD. Yes. All of that makes sense, and some caps in here would seem to make some sense. Tightening some of the procedures would seem to make some sense, and obviously the management controls that you have outlined would make some sense. I very much appreciate the time and effort that you have made.

Now, again, we are running substantially behind our schedule. I know that Mr. Emm of the Intertribal Agriculture Council needs to leave for the airport at 5 o'clock. Maybe we could go directly to him and get a summary of his testimony. Thanks to all of you once again. We appreciate your effort and help. I think we will have more chances to visit as well.

Mr. HARMAN. We are certainly at your disposal.

Senator CONRAD. Mr. Emm. We will ask all of the others who are here as witnesses, Cheryl Cook, Benny Bunting, Gene Severens, and Ralph Paige to come to the table as well. And given the lateness of the hour, it is my intention we will ask each of you to summarize your testimony, and we will take the complete written testimony for the record, and then we will have a chance to ask questions of all of you as panel members.

Mr. Emm, if you want to go ahead, given the fact you have a plane to catch, please proceed.

STATEMENT OF GERRY EMM, VICE PRESIDENT, INTERTRIBAL AGRICULTURAL COUNCIL, RANCH MANAGER, WASHOE TRIBES OF NEVADA AND CALIFORNIA, GENOA, NV

Mr. EMM. Thank you, Mr. Chairman. If I missed that plane, would I be able to go to dinner with you and Sox?

Senator CONRAD. Well, did you notice that Sox left without actually extending a formal invitation?

Mr. EMM. I noticed that.

INTRODUCTION

Mr. Chairman, my name is Gerry Emm, and I am the ranch manager for the Washoe Tribes of Nevada and California. I am also the vice president of the Intertribal Agriculture Council, and want to express our gratitude of our 52 member tribes for your interest and concern as represented by inviting us to the hearing today. The testimony I am giving is intended to provide a overview of the unique features of Indian agriculture and their relationship to agricultural credit provided through the FmHA and the Farm Credit System.

Agriculture remains a vital part of Indian communities today. The 1986 BIA Report to Congress on Agriculture/Range reported that agriculture is the primary contributor to reservation economies, with 33,572 Indian families earning their livings through farming or ranching, 45,000 growing agricultural products as part of a subsistence lifestyle, with 46 million acres of Indian Trust land used for agriculture.

The organization I represent is the Intertribal Agriculture Council (IAC), a private, nonprofit corporation, comprised of dues paying member tribes with an interest in the management and development of their land and agronomic resources. It was founded by charter in November of 1987 to provide a unified effort at promoting change and improvements in Indian agriculture for the benefit of Indian people and communities. Voting membership in the IAC is limited to federally recognized tribes and Native Alaskan associations. The IAC currently represents 52 dues paying member tribes which together control 43 million of the 53.7 million acres of Indian lands in the contiguous United States, and approximately half of the 44 million acres in Alaska. Tribal members pay dues of $200 per year.

The IAC is governed by a board of directors composed of tribal representatives elected from each of the 12 BIA regions and we all serve on a voluntary basis.

IMPORTANCE OF THE FEDERAL CREDIT SYSTEM TO INDIAN PEOPLE

According to the 1984 report on the Presidential Commission on Indian Reservation Economies: "One of the major obstacles to Indian economic development is access to sources of capital by Indian individuals, Indian businesses and Indian tribes."

Off-reservation agricultural operations are based on large private land holdings, sometimes supplemented with much smaller acreages of crop-share, leased land, or Federal grazing permits.

Indian farmers and ranchers generally cannot acquire the majority of their landholding due to the undivided heirship status of the majority of the individually owned Indian lands and legal barriers to the sale of tribal lands. Therefore, most of the land cropped by Indians is land leased from the landowners or tribe under short duration, no-renewable clause leases and permits based on regulations of the Bureau of Indian Affairs. These leased lands cannot be used as collateral for commercial credit, nor do they accrue equity to the farming operation over time.

Constraints and regulations imposed by the various laws and regulations pertaining to the Federal Government's trust responsibility, and the sovereignty of tribal governments also reduce Indian farmer or rancher's access to private capital.

Since the private sector has not been able to meet credit needs of Indian agricultural enterprises, Indian farmers and ranchers have increasingly turned to the Federal Government. And that would be the BIA and Farmers Home Administration.

The Indian Financing Act of 1974 (Public Law 93-262) declared that it is a "policy of Congress to provide capital on a reimbursable basis to help develop and utilize Indian resources . . ." and 10 years later the Indian Financing Act Amendments of 1984 (Public Law 98-449) were enacted to expand original legislation. These two laws are the basis for the financial assistance programs of the BIA. These programs are administered to serve as a primary means of supporting the Bureau's economic development programs, and those enterprises which will provide the most employment opportunities for Indian people and have a good expectation of success receive the highest priority for assistance. Agricultural production generally cannot compete for limited dollars due to employment clauses. Additionally, these programs of potential benefit to Indian farmers and ranchers have relatively small yearly appropriations. For example, on FmHA and BIA guaranteed loans this year after the Gramm-Rudman cuts which all of the agriculture part of this took, $4.4 million was set aside under guaranteed loans for agriculture.

For all the above reasons, the Farmers Home Administration is by far the largest holder of Indian agricultural loans. Increased interest in Indian problems by the USDA has resulted in improved Indian access to programs of the Farmers Home in the past year or two and improved services to Indian farmers and ranchers. Evidence of the improvements can be seen in the recent series of visits to the Northern Great Plain's Reservations by Farmers Home Washington and State officials to discuss existing shortcomings and work on improving service delivery.

RECOMMENDATIONS

LONG-TERM NATURE OF AGRICULTURE PRODUCTION

Our recommendations for these hearings:

Despite the improvement in working relationships with the FmHA, areas for improvement still exist. Foremost among these is the recognition that agriculture is a long-term capital intensive business requiring long-term capital commitment to survive the various climate and market fluctuations which are inherent to agriculture.

The short-term approach to capital is probably the single most critical factor in forcing the numerous farm failures of the early and mid-1980's, and the continuing plight in rural communities today. Therefore, we recommend that the new farm bill address the long-term capital intensive nature of agriculture production, and provide credit opportunities through the FmHA based on projected long-term returns to capital, not short-term market fluctuations.

GUARANTEED VS. DIRECT LOANS

On the guaranteed versus direct loans, the Intertribal Agriculture Council strongly recommends that the new farm bill include language to equitably balance the requirements of the agriculture community and reverse the trend of increasing guaranteed loans. It is important, in our view, to reemphasize the position of the FmHA as the lender of last resort, and prioritize direct lending programs which are designed to recognize the role of the Farmers Home Administration in providing services to the agricultural community, not the financial community.

LAND ACQUISITION PROGRAM

In the past Farmers Home was a primary lender supporting the efforts of tribal governments to repurchase allotted lands and thereby eliminate the fractionated and mixed ownership problems which permeate Indian country today. This Tribal Land Acquisition Program has now been largely abandoned by the USDA, with the result that there is currently no vehicle for tribes to resolve the longstanding heirship programs which directly impact Indian agricultural producers by reducing access to land. The value of consolidating ownership of the highly fractionated heirship lands cannot be overstated. Therefore, we in the Intertribal Agriculture Council suggest that the land acquisition program be reauthorized with suitable appropriation levels to achieve the objective of consolidating ownership of fractionated heirship lands in Indian country.

EMPHASIS ON AGRICULTURE

Finally, it appears that some of the shortcomings reported might result from the loss of mission for the Farmers Home in recent years. Diversifying into rural municipal sewage disposal or recreational facility development may be the approach taken by commercial banks, but it completely ignores the primary function of the Farmers Home as the Federal agriculture lender. There are other organizations and sources of funds to deal with other segments of society. Farmers and ranchers need the Federal agriculture credit source which concentrates on the needs of the American agriculture. We recommend that the role of the Farmers Home Administration as the primary lender of last resort to agriculture be emphasized by concentrating on ag producer loans. If necessary, this could be accomplished by splitting off a separate staff and office function to deal with noncommercial agriculture lending, thereby allowing agriculture loan officers to concentrate on their primary responsibilities.

CONCLUSION

In conclusion, I wish to thank you, Mr. Chairman, for inviting us to participate in these hearings today. We are ready and anxious to assist you in any way possible in addressing the issues mentioned here today and to help correct the deficiencies in the existing farm bill and USDA programs which affect Indian people and others engaged in agricultural production in rural America.

[The prepared statement of Mr. Emm follows:]

Intertribal Agriculture Council

Gerry Emm, Vice President, P.O. Box 322 Genoa, Nevada 89411 702 267-3404

Prepared Statement of the Intertribal Agriculture Council before the February 8, 1990 hearing of the Senate Subcommittee on Agricultural Credit

Introduction

Mr. Chairman, I am Gerry Emm of the Washoe Tribes of Nevada and California. I am the Vice-President of the Intertribal Agriculture Council, and want to express the gratitude of our 52 member tribes for your interest and concern as represented by your inviting us to this hearing today. The Testimony I am giving is intended to provide a brief overview of unique features of Indian Agriculture and their relationship to agricultural credit provided through the FmHA and the Farm Credit System.

Native Americans have strong traditional and economic ties to agriculture. For centuries they cultivated and perfected crops which have now become mainstays of world diet. Several different varieties of potatoes, tomatoes, corn, popcorn, summer and winter squash, bananas, pineapples, avocados, plums, various berries, walnuts, chestnuts, pecans, and filberts, are just a few examples of their contributions.

Agriculture remains a vital part of Indian communities today. The 1986 BIA Report to Congress on Agriculture/Range reported that Agriculture is the primary contributor to reservation economies, with 33,572 Indian families earning their livings through farming or ranching, 45,000 growing agricultural products as part of a subsistence lifestyle, with 46 million acres of Indian Trust land used for agriculture.

The organization I represent is the Intertribal Agriculture Council (IAC), a private, non-profit corporation, comprised of dues paying member tribes with an interest in the management and development of their land and agronomic resources. It was founded by charter in November of 1987 to provide a unified effort at promoting change and improvements in Indian agriculture for the benefit of Indian people and communities. Voting membership in the IAC is limited to federally recognized tribes and Native Alaskan Associations. The IAC currently represents 52 dues paying member tribes which together control 43 million of the 53.7 million acres of Indian Lands in the contiguous United States, and approximately half of the 44 million acres in Alaska. Tribal members pay dues of $200.00 per year.

The IAC is governed by a Board of Directors composed of tribal representatives elected from each of the twelve Indian regions recognized by the Bureau of Indian Affairs. Officers are elected by the Board from its membership, and all members serve on a voluntary basis.

II. Importance of the Federal Credit system to Indian People.

Traditional economic indicators place Indians and Indian reservations at the bottom of the American economic scale. Reasons given for the poor economic conditions on Indian reservations include physical isolation, poor transportation networks, cultural differences, jurisdictional problems and long distances to markets. However, all these characteristics can also be applied to most rural agricultural communities, Indian or non-Indian. The major difference, in our opinion, is the lack of sufficient capital to operate fully successful enterprises.

According to the 1984 Report of the Presidential Commission on Indian Reservation Economies:

"One of the major obstacles to Indian Economic development is access to sources of capital by Indian individuals, Indian businesses and Indian tribes."

Several other task force reports have listed under-capitalization as a major barrier to Indian success. Perhaps the most chronic problem in Indian Country today is the lack of financial resources for Indian people to develop their own potential.

There are several reasons for the generally undercapitalized nature of Indian Agricultural enterprises. These are largely related to the differences between on-reservation and off-reservation agricultural operations. Off-reservation agricultural operations are based on large private land holdings, sometimes supplemented with much smaller acreages of cropshare, leased land, or federal grazing permits. The large land holding associated with the operation provides real collateral for long-term commercial financing.

Indian farmers and ranchers generally cannot acquire the majority of their landholding due to the undivided heirship status of the majority of individually owned Indian lands and legal barriers to the sale of tribal lands. Therefore most of the land cropped by Indians is land leased from the landowners or tribe under short duration, no-renewal clause leases and permits based on regulations of the Bureau of Indian Affairs. These leased lands cannot be used as collateral for commercial credit, nor do they accrue equity to the farming operation over time. Additionally, lease rates may exceed the cash flow requirements for purchase, reducing the economic returns from the land.

Constraints and regulations imposed by the various laws and regulations pertaining to the federal government's trust responsibility, and the sovereignty of tribal governments also reduce Indian farmer or rancher's access to private capital. The involvement of one or more federal bureaucracies in any effort to obtain a mortgage or pledge assets as collateral greatly complicates and slows the loan application process, and may result in increased costs to lending institutions. Additionally, jurisdictional issues associated with foreclosure or collection procedures are generally not clearly defined and lending institutions are reluctant to make loans to Indian operators if foreclosure procedures might fall under tribal jurisdiction.

Since the private sector has not been able to meet the credit needs of Indian agricultural enterprises, Indian farmers and ranchers have increasingly turned to the federal government.

The Indian Financing Act of 1974 (Pl 93-262) declared that it is a

> *"policy of Congress to provide capital on a reimbursable basis to help develop and utilize Indian resources..."*

and ten years later the Indian Financing Act Amendments of 1984 (Pl 98-449) were enacted to expand the original legislation. These two laws are the basis for the Financial Assistance Programs of the Bureau of Indian Affairs. These programs are administered to serve as a primary means of supporting the Bureau's Economic Development programs, and those enterprises which will provide the most employment opportunities for Indian people and have a good expectation of success receive the highest priority for assistance. Agricultural production generally cannot compete for limited dollars due to the employment clauses. Additionally, these programs of potential benefit to Indian farmers and ranchers have relatively small yearly appropriations.

For all the above reasons, the Farmers Home Administration in the Department of Agriculture is the by far largest holder of Indian agricultural loans. Increased interest in Indian problems by the USDA has resulted in improved Indian access to programs of the FmHA in the past year or two and improved services to Indian farmers and ranchers. Evidence of the improvements can be seen in the recent series of visits to Northern Great Plain's Reservations by FmHA Washington and State office officials to discuss existing shortcoming and work on improving service delivery.

III. Recommendations:

A. Long Term Nature of Agriculture Production

Despite the improvement in working relationships with the FmHA, areas for improvement still exist. Foremost among these is the recognition that agriculture is a long term capital intensive business requiring long term capital commitment to survive the various climate and market fluctuations which are inherent in agriculture. When short term reversals, such as drought, are coupled with short term capital commitment, the results are failures and foreclosures, a general market decline and a recession in the agriculture economy. Other long term businesses would also be put into bankruptcy if a negative cash flow in a single quarter or year resulted in an elimination of existing credit lines.

This situation displaced many American farmers and ranchers in the mid-eighties, and the ramifications are still being felt as foreclosures, bankruptcies and "voluntary liquidations" continue. Most of these actions would be unnecessary if long term capital was provided, because the upturn in agricultural markets in the past two years would have provided sufficient capital to retire old debts.

The short term approach to capital is probably the single most critical factor in forcing the numerous farm failures of the early and mid-eighties, and the continuing plight in rural communities today. Therefore we recommend that the new Farm Bill address the long term capital intensive nature of agriculture production, and provide credit opportunities through the FmHA based on projected long term returns to capital, not short term market fluctuations.

B. Guaranteed vs. Direct Loans.

Another concern of the Intertribal Agriculture Council is the current trend to shift the FmHA agriculture loan portfolio away from direct lending to greater emphasis on guaranteed loans. This will not result in improved services to at least the Indian segment of the agricultural community. Since Indian farmers and ranchers must face the problems of smaller scale, lack of large land-based collateral assets, uncertain foreclosure jurisdiction, and issues involving the federal trust status of Indian lands, private lenders are not greatly attracted to guaranteed loans on reservations. Additionally, the experience of Indian ranchers and farmers who were successful in obtaining guaranteed loans is that these loans are the first ones foreclosed upon by the banks during lean years. When the lenders are guaranteed 90% of the face value of the loan there is no incentive to work with the individual borrower to restructure or pull the operation through hard times. Rather, during lean times the guaranteed loans allow the commercial lender the best opportunity to reduce their exposure in agriculture, while transferring the loss to the federal treasury. This program is much more beneficial to the lender than to agricultural producers.

The guaranteed loan program may appear to require fewer federal dollars in the short term, but it also removes the decision on foreclosures from the government and allows commercial credit sources to call for the guarantee at virtually anytime. In reality the Federal treasury has greater exposure and less protection with guaranteed loans than it would if it had direct loans with some semblance of control.

Therefore the Intertribal Agriculture Council strongly recommends that the new Farm Bill include language to equitably balance the requirements of the Agriculture community and reverse the trend of increasing guaranteed loans. It is important, in our view to re-emphasize the position of the FmHA as the lender of last resort, and prioritize direct lending programs which are designed to recognize the role of the FmHA in providing services to the agriculture community, not the financial community.

C. Land Acquisition Program.

In the past the FmHA was the primary lender supporting the efforts of tribal governments to re-purchase allotted lands and thereby eliminate the fractionated and mixed ownership problems which permeate Indian country today. This Tribal Land Acquisition Program has now been largely abandoned by the USDA, with the result that there is currently no vehicle for tribes to resolve the longstanding heirship problems which directly impact Indian agricultural producers by reducing access to the land. The value of consolidating ownership of the highly fractionated heirship lands cannot be overstated. Therefore, we in the Intertribal Agriculture suggest that the Land Acquisition program be re-authorized with suitable appropriation levels to achieve the objective of consolidating ownership of fractionated heirship lands in Indian Country.

D. Emphasis on Agriculture

Finally, it appears that some of the shortcomings reported might result from a loss of mission for the FmHA in recent years. Diversifying into rural municipal sewage disposal or recreational facility development may be the approach taken by commercial banks, but it completely ignores the primary function of the FmHA as the federal agriculture lender. There are other organizations and sources of funds to deal with other segments of society. Farmers and ranchers need a federal agriculture credit source which concentrates on the needs of American agriculture. We recommend that the role of the FmHA as the primary lender of last resort to agriculture be emphasized by concentrating on agriculture producer loans. If necessary, this could be accomplished by splitting off a separate staff and office function to deal with non-agricultural lending, thereby allowing agriculture loan officers to concentrate on their primary responsibilities.

IV. Conclusion

Thank you, Mr. Chairman, for inviting us to participate in these hearings today. We are ready and anxious to assist you in anyway possible in addressing the issues mentioned here today, and to help to correct deficiencies in the existing Farm Bill and USDA programs which affect Indian people and others engaged in agricultural production in rural America.

Senator CONRAD. Thank you very much for taking the time to participate with us here today. We certainly appreciate it. Next we will hear from Cheryl Cook, legislative analyst for the National Farmers Union. Welcome.

STATEMENT OF CHERYL COOK, LEGISLATIVE ANALYST, NATIONAL FARMERS UNION, WASHINGTON, DC

Ms. COOK. Thank you, Mr. Chairman.

INTRODUCTION

It seems that every time you have a credit hearing, I end up getting a cold and losing my voice. I decided I better make sure my Blue Cross is paid up before you start markup. I appreciate the chance to be here today to talk again about the trends that we have seen in the Farmers Home Administration's loan programs.

SEVERAL CONCERNS

We do have several concerns. First, and perhaps most importantly, we are concerned about the impact of the shift from direct to guaranteed lending, as has already been discussed in detail today. We feel that our belief that guaranteed lending is not acting as a substitute for direct lending, not reaching the same types of borrowers or meeting the same types of credit needs, has largely been substantiated by the GAO report so I will not go into more detail on that.

Our second major area of concern is that Farmers Home be given the resources necessary, particularly staff resources, to perform the very important supervisory tasks. Lower interest rates are fine, and they have helped tens of thousands of borrowers get their start in agriculture, but what has kept them there, what has made them successful, was the financial management skills that they learned from working with their County Supervisor. These supervisory needs are there in both the direct and guaranteed loan programs, and we would hope that the 1990 farm bill would include a substantial increase in Farmers Home staffing.

We feel that kind of thing can head off a delinquency long before it is a delinquency. We can find the problems early, get them solved when it genuinely is the least cost alternative for the Farmers Home Administration. And particularly, if we are going to add new duties for rural development to Farmers Home's already massive array of services that they are expected to offer, we have got to do something about their staff needs.

Our third major area of concern stems from announcements over the last 2 weeks of both President Bush's proposed budget for fiscal year 1991 and recent announcements of USDA's farm bill proposal for 1990. As has already been discussed, from 1985 to 1989 direct lending plummeted in Farmers Home, while guaranteed loan activity increased only slightly. And I am not going to suggest that agricultural credit is a static number or is anything less than a fluid concept, a moving target as you said, but we find it hard to believe that you can decrease over 60,000 direct loans out of category A, increase the category B guaranteed loans by under 2,000, and still claim that credit demand is being met.

Clearly, credit demand is not being met, and we were very concerned to see an even greater emphasis on guaranteed lending for fiscal year 1991. We believe that the allocations that were in 1985, approximately $3 billion to direct lending and $1 billion to guaranteed lending, resulted in the optimal use of funding for the various loan programs.

FARM BILL PROPOSAL

USDA's farm bill proposal calls for several changes in the operation of Farmers Home programs that we believe are necessarily in the best interest of farmers or taxpayers.

First, the proposal recommends maximum use of private lenders' forms, standards, practices and terminology. While the goal of Farmers Home's direct lending should be to prepare borrowers for private sector lending, by definition FmHA eligible borrowers cannot meet private lending standards. Farmers Home was never intended to be a clone of a private bank, and we are concerned that over reliance on private lending procedures could result in an even greater problem of unmet credit demand.

Second, their proposal calls for 20 percent downpayment or 20 percent equity in guaranteed loans. This seems totally excessive. Anybody who has got 20 percent of their purchase price available for a downpayment probably does not need the Government's help to get private lending in the first place.

Third, the proposal calls for limiting borrowers to one write-down opportunity, and applying write-down authority only to those loans closed as of date of enactment of the Agricultural Credit Act of 1987. Much of the existing total of delinquent loans, we believe, can be attributed to interest on interest caused by Farmers Home's own failure to resolve their problem loans in a timely manner consistent with law and regulation. It would be most unfortunate if a few isolated instances of abuse resulted in tying the agency's hands and keeping it from using its least cost alternative. Mr. Johnson testified earlier that the 1987 act gave them the means to deal with troubled borrowers in a compassionate way. From our vantage point, the only real change in their authority in the 1987 act was the ability to use write-downs prior to foreclosure. Now they seem to want to give that tool back, and we do not believe that that is necessary.

Fourth, the proposal recommends increasing shared appreciation periods to 10 years for cases of net recovery buyout in an effort to be consistent with the act's 10 year provision on purchases out of inventory. We believe that the entire point of a shared appreciation is to keep a borrower whose loan obligations have been reduced from recognizing a windfall profit, and that that is a fair concept. But we are very concerned that by creating this consistency, we will also extend the idea consistently in all shared appreciation arrangements that at the end of 10 years the loan is reappraised and the value is tacked back on the end of the loan regardless of whether the borrower is actually trying to sell the property, regardless of whether any gain is actually realized.

That kind of consistency we do not need. We need to get a fair program all the way across the board.

And finally, and perhaps the most troubling of all of their proposals for the farm bill, they recommend turning the Farmers Home guaranteed loan secondary market over to Farmer Mac. We object to this proposal primarily because we do not believe that Farmer Mac itself should be in the business of pooling loans. They should at best be arm's length from the pooler; they should act more as a regulator than as a direct pooler themselves. In addition, we question the wisdom of using Farmer Mac for marketing paper that is backed by loans that cannot possibly meet Farmer Mac's underwriting standards.

While this would take the problem of setting up what amounts to a junk bond market for agricultural loans out of the hands of FmHA, we question what sort of liability that could set up for Farmer Mac and ultimately for the Government through its guarantees.

SUMMARY

In summary, we have several serious concerns with where Farmers Home has been and where they are still going, and we would appreciate the opportunity to keep working with you in the farm bill process. Thank you.

[The prepared statement of Ms. Cook follows:]

NATIONAL
FARMERS
UNION

Testimony of

the National Farmers Union

before the

Subcommittee on Credit
Senate Committee on Agriculture, Nutrition, and Forestry

February 7, 1990

600 Maryland Avenue, S.W. • Suite 202W • Washington, D.C. 20024 • Phone (202) 554-1600

Testimony of the National Farmers Union before the Subcommittee on Credit, Senate Committee on Agriculture, Nutrition, and Forestry, February 7, 1990.

Mr. Chairman, I am Cheryl Cook, a legislative analyst for the National Farmers Union here in Washington, D.C. I would like to thank you on behalf of our members for conducting these hearings on trends in the loan programs of the Farmers Home Administration (FmHA). National Farmers Union has been concerned with the direction that FmHA lending has been going for the last decade. We are especially concerned with the impact of the Congressional mandate to increase guaranteed lending at the expense of the direct lending program.

In March of 1989, National Farmers Union's membership adopted the following policy at its annual meeting:

"We strongly oppose phasing out FmHA's direct lending activities. The guaranteed loan program has not been attractive to commercial lenders, and those who have participated have found the program poorly administered. Overall, the guaranteed program has not become the low-cost substitute for direct lending that Congress expected it to be, and we are concerned that budget-driven efforts to lower the level of government guarantee would render the program totally useless. We recommend greater use of the direct loan program, better use of the guaranteed loan program, and identical loan ceilings under both programs."

Six months later, the GAO issued a report on the implications of the shift in FmHA's lending from direct to guaranteed. This report entitled "Farmers Home Administration - Implications of the Shift From Direct to Guaranteed Farm Loans", substantiated the concerns that our membership had about how the FmHA guaranteed lending programs were working. A brief review of the GAO's findings show that:

a. shifts to guaranteed loans have resulted in private lenders guaranteeing loans already in their portfolio that have become financially stressed;

b. few direct FmHA borrowers have been graduated to guaranteed loans or are likely to be graduated;

c. although guaranteed loans help high-risk borrowers obtain private credit, such borrowers have higher cost of money, stricter loan terms, and a greater likelihood of liquidation because of private lender policies;

d. guaranteed loans benefit private lenders. The increase in guaranteed loans has helped keep some farm lending in the private sector and reduced budgetary outlays for direct lending. However, because of the increase in outstanding principal for guaranteed loans has outpaced the decrease in that of direct lending, the governments overall financial exposure has increased; and

e. FmHA's inadequate assessment of borrowers' financial condition prior to loan guarantee approval and insufficient oversight of approved loan guarantees have contributed to guaranteed loan losses, which have increased at a faster rate since 1984 than has guaranteed loan activity. The greater the loan losses, the greater the impact on the budget outlays.

Mr. Chairman, we are concerned that the shift from direct to guaranteed loans at FmHA will result in a number of changes in: the basic mission of FmHA; who will get FmHA loans; and the number of loans that will be made by FmHA. We are also fearful that it will ultimately cost the Federal Government as much or more than the direct lending program.

FmHA was designed by Congress to be the lender of last resort for beginning farmers, limited resource farmers and those facing adversity. It was designed to provide supervised credit to these individuals and eventually graduate them to private credit when the strength of their operation warranted it.

Mr. Chairman, there are tens of thousands of successful farmers in operation today because of this mission of FmHA. They have benefited from the lower interest rate of FmHA in getting started, however the real key was the supervision that FmHA offered. The "Farm and Family Plan" that was required by FmHA helped many beginning farmers to establish a planning and management capability that was needed for a successful operation.

Likewise, the guidance of the FmHA county supervisor was an important asset to the beginning farmer. A loan officer trained to assist the operator in financial management decisions was a valuable resource. It helped to ensure that financial decisions were based on the needs of the operation and the capacity of the operator, designed for the financial success of the enterprise.

The FmHA County Supervisor was a person who frequently visited the operation, a person who sat around the kitchen table helping the farm family make the difficult financial decisions necessary. If changes or midway course corrections were needed in the operation, this could be done.

This is a far cry from the picture that the GAO paints of the situation resulting from the guaranteed loan program. In its report GAO states:

"While FmHA's guaranteed farm operating and ownership loan activity has significantly increased since 1984, losses have grown at a faster rate. Loan delinquencies are also growing, and FmHA projects that losses on guaranteed loans will increase in the future. Because lenders generally obtain guaranteed loans for financially stressed farmers, losses on such loans can be expected. Although some loan losses may be attributable to uncontrollable factors such as adverse weather conditions and a poor farm economy, problems in FmHA's assessment of borrowers' financial conditions prior to loan guarantee approval and in FmHA's oversight of lenders' servicing of loan guarantees after approval have also contributed to guaranteed loan losses."

The need to improve on FmHA's supervision of credit is not limited to the guaranteed program. The plain fact is the agency does not have the staff required to provide for its original mission of supervised credit. Congress should take a serious look at the staffing of the FmHA and determine if an increase of personnel could result in a budget savings through reduced delinquencies and fewer foreclosures.

A second area of concern is who will get the FmHA guaranteed loan, and at what cost. The original intent of FmHA was that it would help beginning farmers, limited resource farmers and those facing adversity. The guaranteed loan program appears to assist only the latter category. Again lets look at the findings of the GAO report:

"According to the FmHA state and county and private lending official we interviewed, private lenders are primarily obtaining loan guarantees to cover loans made to their financially stressed customers who have either marginal loan security, marginal cash flow, or poor debt-to-asset ratios and insufficient net worth. The OIG confirmed this situation in its September 1988 report that projected that 99 percent of the 15,585 guaranteed loans in its sample universe were used to finance lender clients. In addition, we found that some lenders obtain guarantees to avoid having bank examiners classify the loans as substandard."

Given this situation it is very unlikely that a new borrower in either the beginning or limited resource category will be considered for a guaranteed loan by a commercial lender. In addition private lenders may have been using the guaranteed program to dump their bad loans on the FmHA. In Iowa, a grand jury was asked to look at allegations by a former Production Credit Association (PCA) employee, that PCA loan officers were encouraged to mislead FmHA to obtain guarantees on loans that had losses and that the PCA's were going to foreclose.

Again the GAO report indicates that the guaranteed loan program lends itself to an environment in which this could happen:

"As guaranteed loan activity has increased so have guaranteed loan losses and FmHA expects such losses to increase in the future. Contributing factors to the increasing losses on guaranteed loans are problems in FmHA's assessment of a borrower's financial condition prior to approving the guarantee and in FmHA's oversight of the loan guarantee after approval. Problems such as poor assessment of a borrower's repayment ability, insufficient determination of collateral securing a guaranteed loan, inadequate credit analysis training for FmHA county supervisors, and unclear guidance for determining the percentage of guarantee demonstrate that FmHA needs to take a more comprehensive approach to reviewing and approving lender' loan guarantee request."

In addition to making guaranteed loan primarily only to existing loans in their portfolio, it is apparent that these borrowers would be much better off using a FmHA direct loan program. Prior to FmHA publishing new guaranteed loan regulation in January of 1989, lenders routinely charged higher rate for the FmHA guaranteed loan than they did for their average loan customer.

It is inconceivable that the guarantee program could ever replace the direct loan program for beginning and limited resource farmers. The reason for this is that the bank charges so much more for the guaranteed loan than FmHA does for their direct loans. Again lets look at the GAO report:

"Although guaranteed loans enable borrowers to obtain credit at interest rates lower than what they would normally have to pay because of their being high-risk borrowers, the interest rates on guaranteed loans can range from about 3 to 7 percent higher than FmHA direct loan interest rates. To illustrate, the median interest rate private lenders charged on the guaranteed operating loans to the 67 borrower in our sample was 11.9 percent. In contrast, during fiscal year 1987 the FmHA regular direct loan interest rates ranged from 7.5 to 9.25 percent; and the limited resource interest rate, which is a government subsidized rate, ranged from 4.5 to 5.75 percent. FmHA provides the limited resource rate to those borrowers who cannot make loan payments at its regular interest rates. According to FmHA's September 30, 1987 and 1988, Status of Loan and Grant Obligations Allotments or Distributions reports, FmHA made about 64 percent of its direct farm operating and ownership loans at its limited resource interest rates."

In addition to the lower rates FmHA also charges a one percent loan fee to the commercial lender for guaranteed loans. This loan fee is usually passed on to the borrower.

It is plain to see that the guaranteed loan does skew the types of borrowers that use FmHA programs. Instead of helping farmers get started, the guaranteed programs help those that have faced adversity after having obtained private credit. It would also appear that the major benefactor of the guaranteed program is not the borrower, but the financial institution. Given the Administration's proposal for a new interest rate buydown on guaranteed loans that does not require a similar contribution from the private lenders, the guaranteed loan programs could become even more of a bailout for private lenders seeking to avoid problems with their existing loans and the FDIC.

The third area of concern is whether the shift from direct lending to guaranteed is meeting the needs of traditional FmHA clientele. Beginning in fiscal year 1984 FmHA started to place greater emphasis on guaranteed loans.

The Food Security Act of 1985 supported the shift from direct farm loans to loan guarantees by reducing authorizations for direct loans and increasing authorizations for guaranteed loans. In fact, of the $4 billion authorized in FmHA lending in 1985, about $3 billion was for direct lending and $1 billion was for guaranteed. By fiscal year 1988, those figures were reversed.

In 1985, there was just about optimal utilization of FmHA obligations. There was 100% utilization of FmHA's direct lending in both the farm ownership and farm operating categories and 99.9% use of guaranteed farm ownership and 94.7% use of guaranteed farm operating. By 1989, there was 99.95 use of the direct farm ownership and 91.8% use of the direct farm operating funds. However, the use of the guaranteed funds had fallen to 41.3% for the guaranteed farm ownership and 33.8% for the guaranteed farm operating.

Further analysis shows that in 1989, in the farm ownership category, there were 10,175 applications in which only 1,171 or 11.5% of those applying were successful in attaining a direct FmHA loan. In the guaranteed farm ownership there were 2,851 applications with 2,085 or 73.1% were successful. A far greater number of FmHA eligible borrowers desired direct loans to guaranteed. The ratio of loan applications for direct versus guaranteed was 3.57:1.

In the 1989 farm operating category, there were 29,741 applications for direct loans with 20,510 or 68.9% of the applicants successfully funded. In the guaranteed operating loan program there were 9,975 applications with 9,857 or 98.85% funded applications. Again, more FmHA eligible borrowers were seeking direct loans. The ratio of loan applications for direct verses guaranteed in the farm operating category was 2.98:1.

In 1985, FmHA made 83,929 direct loans and 10,146 guaranteed loans for a total of 94,075 loans. In 1989, FmHA made 22,681 direct loans and 11,942 guaranteed loans for a total of 34,623. In other words, FmHA made 59,452 fewer loans in 1989.

This drop in loan volume is due largely to the reversal in the ratio of the appropriation from direct to guaranteed loan programs. By emphasizing guaranteed loans at the expense of the direct lending program, FmHA has failed to meet its historical mission of providing supervised credit to beginning and limited resource farmers. It is time for Congress to correct the misdirection of the 1985 Act and restore a proper balance of appropriations between direct and guaranteed lending.

This is in the best interest of the federal government, the FmHA clientele and the agricultural community. I thank you, Mr. Chairman, for the opportunity to discuss these issues with you. I pledge the support of National Farmers Union to make the needed changes, and I will try to answer questions that you might have at this time.

Senator **CONRAD**. Thank you very much. Next we will hear from Pam Baldwin of the National Save the Family Farm Coalition. Welcome. Thank you for your patience.

STATEMENT OF PAM BALDWIN, ON BEHALF OF THE CREDIT COMMITTEE, NATIONAL FAMILY FARM COALITION, MERIDIAN, ID

Ms. **BALDWIN**. Thank you, Mr. Chairman.

INTRODUCTION

I appreciate the opportunity to share our views on the credit issues that are facing family farmers in the 1990's. I own and operate a 150 head dairy operation with my husband and 4 children in Meridian, Idaho. I currently serve as president of the Idaho Rural Council, and I operate a farm crisis hotline in the State.

I would request that there be a time period that our other member organizations of the Family Farm Coalition could submit written testimony to this hearing.

Senator **CONRAD**. That is fine. We will leave the record open for 2 weeks.

Ms. **BALDWIN**. Thank you. I testify here today on behalf of the Credit Committee of the National Family Farm Coalition (NFFC), an organization representing over 40 organizations in 32 States working to strengthen family farm systems of agriculture. We worked closely with your subcommittee before on the development of the borrowers' rights provisions of the Agricultural Credit Act of 1987 and we really appreciate your help in getting borrowers' rights for us. We remain concerned about the future of the 80,000 FmHA borrowers who have received notices under the new law and are working to process their restructurings. Secretary Yeutter's proposal is a dismantling of the Agricultural Credit Act of 1987 and a drastic shift in the availability of accessible agricultural credit. When President Reagan signed the bill into law, he expressed his opposition to FmHA reforms and called for future congressional action. We view Secretary Yeutter's farm bill proposal and President Bush's budget as following this mandate.

THE 1990 FARM BILL MUST ADDRESS THE NEEDS OF FAMILY FARMERS TO RATIONAL POLICIES THAT ENABLE FARMERS TO RUN A VIABLE BUSINESS THAT PROVIDES US WITH A RETURN ON OUR INVESTMENT

The 1990 farm bill must address the needs of family farmers to rational policies that enable farmers to run a viable business that provides us with a return on our investment. This translates into receiving a price at the farmgate that covers our cost of production through a higher loan rate. Farmers could actually feel good about themselves and have an active part in revitalizing our rural, therefore our total economy.

I know this is a hearing on credit policies, but without an adequate income it is hard to envision that many of the farmers, such as myself, who have struggled to survive the 1980's with the tools of debt restructuring and somewhat increased prices during 1989 will have much hope in surviving the 1990's. Congress can legislate reentry farming programs, but if you lose money year after year, there is no incentive for future generations to stay in the business. This directly affects the health of our rural communities.

CONTRACT FARMING OPERATIONS

One issue that we would like to address just very briefly is contract farming operations. This may remove some of the short-term risks, yet a farmer's survival is dependent on large corporations. As a poultry farmer in North Carolina stated, "We have become serfs on our own land." The 1990 farm bill needs to establish policies that enable farmers now on the land to make a decent living and to provide entry opportunities for new farmers. There must be programs focused on the ongoing crisis in minority land ownership with specific programs enacted to stem this disturbing trend.

Our coalition supports testimony that will follow on issues of minority rights. Personally, my own production and living costs are rising, and on Friday when I picked up my milk check, it was $1,500 less than I expected due to a $2 cut in cheese price. It is very difficult to operate any kind of a business with that kind of instability.

ACCESSIBLE CREDIT WITH FAIR INTEREST RATES IS A KEY INGREDIENT TO MAINTAINING OUR OPERATIONS

Accessible credit with fair interest rates is a key ingredient to maintaining our operations. For many family farmers who have developed their debt restructuring plans in 1989, the increase in interest rates changed the feasibility of their entire plan. Many of these farmers are still searching for credit to purchase their operations under net recovery buyout. Scarcity of credit is not only a problem for farmers with distressed loans.

I am aware of well-established farmers with a 3-to-1 debt/asset ratio, with cash-flowing operations that are being refused commercial loans and are unable to obtain FmHA guaranteed loans or direct loans. Commercial lenders are not seeking ag loans because of the volatility of the commodity prices and the uncertain future of agriculture. Farmer Mac may be 3 to 5 years away and guarantees no borrowers' rights. I would not send my worst enemy to Farm Credit Services, and I say that because on my own loan, which I was lucky enough to get restructured, we received yesterday a certified letter saying that because our collateral had slipped we were now in danger of being foreclosed on again. There is no allowance for a second restructuring with Farm Credit Services, but we will give it our best shot. States are losing their lender liability rights because banks are committing fraud and giving bad management advice to farmers. They no longer want to be financially responsible to their borrower or to the bank's shareholders. In Oregon last year, an anti-lender liability law was passed so now neither small businesses or farms may file lender liability suits. There is such a bill in the Idaho State Legislature currently, and it goes to hearing next week.

THE SITUATION

FmHA has slashed direct operating and ownership loans, and we would suggest that these rates be raised to the 1985 level. In South

Dakota, there are farmers paying 13 percent interest rates on guaranteed loans, a higher rate than conventional loans. The guaranteed loan program merely transferred the risk and in some cases the interest costs of lending from the commercial sector to FmHA. The issue is even worse for many farmers who were caught with failing banks. Their loans were taken over by FDIC who immediately moved to foreclosure and then refused to participate in mediation to provide borrowers with debt restructuring options.

Many borrowers are being ignored at the county level across the country. Farmers were being denied loans, frozen out and sold out without the right of appeal under the Food Security Act of 1985. Farmers successfully took FmHA to court resulting in the court injunction holding up FmHA action pending major changes in the practices.

Since then, we have over 80,000 borrowers who have received their debt restructuring notices, yet only 4,608 borrowers were eligible for debt write-down. The high number of net recovery buyouts that are pending reflect both the inability of borrowers to secure financing and in some cases deliberate delays by FmHA based on "bad faith" assertions that they may or may not be affected by pending legislation. We remain concerned that borrowers may be denied their rights based on FmHA errors over the last decade. The high rate of reversals on appeals is further proof that many farmers have been given incorrect information on the local level.

PROPOSALS FOR CHANGES IN THE CREDIT TITLE OF THE 1990 FARM BILL

I will briefly review our proposals for changes in the credit title of the 1990 farm bill.

OUTREACH ON FMHA PROGRAMS

We support improved outreach education through FmHA local offices with special emphasis on outreach to minority farmers where information has not been accessible.

DIRECT LENDING

On direct lending, we would like more appropriation of funds to direct loan programs, and move funding out of the guaranteed loan program.

We support targeting direct ownership and operating loans to farmers with the greatest need. We support applying the targeting provisions for socially disadvantaged farmers meeting the Small Business Administration's definition to direct farm operating loans with a pooling of new funds that will be allocated based on high impact regional needs. We also propose reforming current allocation procedures for operating loans that currently jeopardize planting and management decisions for farmers in certain regions of the country.

We support a graduation program from FmHA to other local credit when it is feasible by the individual operation. There should be guidelines and assistance through community based organizations, the extension service, community colleges, or contracted services to assist in the transition when feasible. We do not support an arbitrary year limit which could put farmers out in the cold.

ENTRY/REENTRY FARMING

On entry and reentry farming, we support an expansion of the interest rate buydown program to a level that will significantly help entry or reentry farming operations. At minimum, these regulations should apply to all loans written since the enactment of the Agricultural Credit Act of 1987 on January 6, 1988. FmHA's delay in issuing regulations should not be costing the borrowers and taxpayers millions in interest costs.

NEW BEGINNINGS

This program would establish a new and separate direct loan fund that would fund the operating and Farm Ownership loans of farmers that are first time or reentry farmers. These funds would be targeted based on a percentage of minorities in the rural county and would be allocated based on eligible borrowers who either meet the socially disadvantaged criteria or meet income criteria designed on high impact areas.

SUSTAINABLE AG PROVISIONS

We are very concerned about the sustainable ag portion of the farm bill. We want credit policies to enable farmers to make changes in their farming operations and fertilizer usage, farm plans to reflect their assertion of estimated costs for chemical inputs and we want FmHA to encourage this when possible.

We have farmers in our area who have made out plans based on sustainable ag practices which are optimum fertilizer inputs and had County Supervisors change those back to the original chemical input to the farms, and that can make a big difference when you are figuring a slim budget.

COUNTY COMMITTEE ELECTION REFORMS

We would like county committee election reforms. The Agricultural Credit Act established some new provisions enabling borrowers to serve as elected county committee members, and we would like to see that plus really intensive and maybe some new training for those county committee members.

MEDIATION PROGRAMS

The law should require participation in mediation when it is the least cost alternative and have it apply also to Small Business Administration, FDIC, and Farm Credit System institutions. The credit title should specify the role of mediation in those States where there is not a State certified program to ensure that farmers are receiving appropriate mediation services, and this is especially important in light of the new lender liability laws.

INVENTORY LAND

Since the enactment of the Agricultural Credit Act of 1987, 80 percent of the land being sold out of inventory has been sold to

FmHA-eligible borrowers. The 1990 credit title needs to preserve the priority and appraisals provision in the 1987 Agricultural Credit Act. Without this, family-sized farmers will be outbid by others in the repurchasing of the farms.

Farmers whose land was in inventory on the date of enactment should receive notices about their rights under the Agricultural Credit Act of 1987. FmHA has taken the position that they had received notice under the Food Security Act and that they did not have to renotice despite new rights for repurchase under the 1987 law. If the land has already been sold out of inventory or leased, the previous owner should also receive notice with the option to enter into a lease/option for their property.

CONSERVATION EASEMENTS

On conservation easements, we would like FmHA inventory land being repurchased or leased by the previous owner to have the option of the conservation easement *unless* the easement is on land that covers existing wetlands which have not in any of the preceding 5 years been used as crop or pastureland.

APPEALS SYSTEM

On appeals: the high reversal rate on FmHA appeals is a sign of how badly this appeals system has been needed by FmHA borrowers who have been consistently denied their rights. The National Appeals Staff must have the authority to enforce decisions that have been overturned with State FmHA officials. Repeated reversals against the same County Supervisor should be recorded in their personnel file and acted upon accordingly. I am also a little concerned about the program to allow review by the farm program directors of plans that they think will be appealed. This will be a good mediation process and perhaps they will come back and be mediated before appeals. But it will also not show up the number of problems there are with County Supervisors making incorrect judgments.

RETIREMENT HOMESTEAD

The level of farm assets held by farmers nearing retirement makes it critical that Federal policies recognize these trends. While the Agricultural Credit Act provides opportunities for debt restructuring and homestead protection, these provisions have proved to be inadequate for farmers over 60 years of age. Homestead agreements still require rental payments or market value buyouts of a homeplace. Farmers have worked all their lives to own these farms and many times they have paid for them several times over in interest payments. Restructuring agreements often use unrealistic 20-year farming plans for farmers who will not live long enough to carry those plans out.

We recommend that Congress create a special provision in the 1990 farm bill to deal with the special situation of elderly farmers. The relative cost of providing services to displaced senior citizen farmers needs to be balanced against allowing farmers to stay on their farms.

CONCLUSION

In conclusion we look forward to working with the subcommittee to develop a comprehensive credit title for the 1990 farm bill that initiates new programs while strengthening the programs established in the Agricultural Credit Act of 1987. These proposals need to address the overall access to credit, reforms in the Farmers Home Administration as well as enforcement of borrowers' rights provisions applying to the Farm Credit Administration. Thank you for this opportunity to be here and we will be more than happy to answer any questions.

[The prepared statement of Ms. Baldwin follows:]

National Family Farm Coalition

80 F Street, N.W., Suite 714 Washington, D.C. 20001 (202) 737-2215

TESTIMONY OF PAM BALDWIN
ON BEHALF OF THE CREDIT COMMITTEE,
NATIONAL FAMILY FARM COALITION
BEFORE THE SENATE SUBCOMMITTEE ON AGRICULTURE CREDIT
February 8, 1990

I appreciate the opportunity to share our views on Credit issues facing family farmers in the 1990's. I own and operate a 150 head dairy operation with my husband and four children in Idaho. I currently serve as President of the Idaho Rural Council and coordinate a Farm Crisis Hotline working with Idaho farmers.

I testify here today on behalf of the Credit Committee of the National Family Farm Coalition (NFFC), an organization representing over 40 organizations in 32 states working to strengthen the family farm system of agriculture. We worked closely with this Subcommittee to develop the borrower's rights provisions of the Agricultural Credit Act of 1987 and appreciate your leadership in monitoring its implementation to ensure that it is working for farmers across the country. We remain concerned about the future of the 80,000 FmHA borrowers who have received notices under the new law and are working through the process. Secretary Yeutter's proposal is a dismantling of the Agricultural Credit Act of 1987 and a drastic shift in the availability of accessible agricultural credit. When President Reagan signed the bill into law, he expressed his opposition to FmHA reforms and called for future Congressional action. We view Secretary Yeutter's Farm Bill proposal and President Bush's budget as following this mandate.

The 1990 Farm Bill must address the needs of family farmers through rational policies that enable farmers to run a viable business that provides us with a return on our investment. This translates into receiving a price at the farmgate that covers our cost of production through a higher loan rate. Farmers could actually feel good about themselves and have an active part in revitalizing our rural, therefore our total economy.

I know this is a hearing on credit policies - but without an adequate income - it is hard to envision that many farmers such as myself who have struggled to survive in the 1980's with the tools of debt restructuring and somewhat increased prices during 1989 will have any hope of making it past 1990. Congress can legislate re-entry farming programs but if you lose money year after year there's no incentive for future generations to stay in the business. This directly affects the health of our rural communities.

For many sectors of the farm ~~economy~~ this uncertainty over credit and income has led to contract farming operations. This may remove some of the short-term risks yet a farmers' survival is dependent on large corporations. As a poultry farmer in North Carolina stated, "We have become serfs on our own land." The 1990 Farm Bill needs to establish policies that enable farmers now on the land to make a decent living and to provide entry opportunities for new farmers. There must be programs focussed on the ongoing crisis in minority land ownership with specific programs enacted to stem this disturbing trend.

Our production and living costs continue to rise yet my net income dropped $1500 when my milk check arrived this past Friday. This came as quite a shock as milk prices seemed to be rising across the country. Costs of production range from $9 - $15/cwt yet our price our prices are very low. The cashflow that I developed last Spring as one of the "lucky" few who did restructure through Farm Credit System has been placed in jeopardy by our loss in income from dairy market instability and budget cuts along with drastic increases in our feed costs. Accessible credit with fair interest rates is a key ingredient to maintaining our operations. For many family farmers who developed their debt restructuring plans in 1989, the increase in interest rates changed the feasibility of their entire plan. Many of these farmers are still searching for credit to purchase their operations under net recovery buyout. Scarcity of credit is not only a problem for farmers with distressed loans.

I am aware of well established farmers with 3/1 asset ratios with cash flowing operations that are being refused commercial loans and are unable to obtain FmHA Guaranteed or Direct loans. Commercial lenders are not seeking ag loans because of the volatility of commodity prices and the uncertain future of agriculture. Farmer Mac may be 3-5 years away and guarantees no borrowers' rights. I wouldn't send my worst enemy to FCS. States are losing their lender liability rights because banks are committing fraud and giving bad management advice to farmers. They no longer want to be financially responsible to their borrower or the bank's shareholders.

THE SITUATION

FmHA has slashed direct operating and ownership loans since 1985 under the guise that the increased guaranteed loan program would provide necessary credit. GAO, OIG, and other studies reinforce concerns heard from farmers around the country. 99% of the farmers that have received guaranteed loans had been commercial borrowers. In South Dakota there are farmers paying 13% interest rates on guaranteed loans - a higher rate than conventional loans. The guaranteed loan program merely transferred the risk and in some cases the interest costs of lending from the commercial sector to FmHA. The issue is even worse for many farmers who were caught with failing banks. Their loans were taken over by FDIC who immediately moved to foreclosure and then refused to participate in mediation to provide borrowers with debt restructuring options.

The 1985 Food Security Act provisions for FmHA borrowers were being ignored at the county level across the country. Farmers were being denied loans, frozen out and sold out without right of appeal. Farmers successfully took FmHA to court resulting in the court injunction holding up FmHA action pending major changes in the practices.

Since the bill's enactment on January 6th, 1988 over 80,000 borrowers have received their debt restructuring notices yet only 4,608 borrowers as of FmHA's January 22nd analysis were eligible for a debt write-down. The high number of net recovery buyouts that are pending reflect both the inability of borrowers to secure financing and in some cases deliberate delays by FmHA based on "bad faith" assertions that may or may not be affected by pending legislation. We remain concerned that borrowers may be denied their rights based on FmHA's errors over the last decade. The high reversal rates on Appeals is further proof that many farmers have been given incorrect information on the local level.

PROPOSALS FOR CHANGES IN THE CREDIT TITLE OF THE 1990 FARM BILL:

Outreach on FmHA Programs:

Family farmers need access to reliable information about their options whether it is for restructuring or availability of other lending programs. We support improved outreach and education through the FmHA local offices with a special emphasis on outreach to minority farmers where the information has often not been accessible. There should be additional staffing based on the percentage of farmers meeting the socially disadvantaged definition in a particular state or county with adequate training provided on a local level.

Direct Lending:

Appropriate more funds in FmHA's direct loan programs, and move funding out of the guaranteed loan program. Farm Ownership and Operating loan funds should be restored to their 1986 levels. For Farm Ownership that level is $260 million. For Farm Operating this level is $1.740 billion. The need to restore these funding levels is in response to the failure of the 1985 Food Security Act movement towards guaranteed lending which only served 1% of the direct lending borrowers. USDA's FY 1991 budget proposal to cut FmHA Direct Farm Ownership by over 50% - reducing it from $90 million to $38 million is a major step in the wrong direction.

We support targetting direct ownership and operating loans to farmers with the greatest need. We support applying the targetting provisions for socially disadvantaged farmers meeting the Small Business Administration (SBA) definition to Direct Farm Operating Loans with a pooling of new funds that will be allocated based on high impact regional needs. We also propose reforming current allocation procedures for operating loans that currently jeopardize planting and management decisions for farmers in certain regions of the country.

We support a graduation policy from FmHA to other local credit when it is feasible by the individual operation. There should be guidelines and assistance through community based organizations, community colleges, or contracted services to assist in the transition when feasible. We do not support an arbitrary year limit which could put farmers out in the cold.

Entry/ Re-entry Farming:

We support an expansion of the interest rate buydown program to a level that will significantly help entry or re-entry farming operations. The current program has not been working very effectively due to limited use of FmHA Guaranteed Loans and other problems. The maximum interest rate charged should be set by FmHA, not the individual bank. FmHA regulations issued 1/13/89 for Guaranteed Loans state that interest rates cannot be higher than the normal rate charged to average farm customers. This average needs to include higher risk borrowers. At a minimum, these regulations should apply to all loans written since the enactment of the Agricultural Credit Act of 1987 on January 6, 1988. FmHA's delay in issuing regulations should not be costing borrowers and taxpayers millions in interest costs.

The USDA FY 1991 budget merely calls for an average 3% reduced interest rate - from 12.5 to 9.5 for $400 million total value of loans. This limited program won't meet the needs of the millions in limited resource loans or current direct lending participants. The interest rate subsidy is a key ingredient in whether the loans are feasible.

New Beginnings:

This program would establish a new and separate direct loan fund that would fund the operating and farm ownership loans of farmers that are first time or re-entry farmers. These funds would be targetted based on the percentage of minorities in the rural county and would be allocated based on eligible borrowers who either meet the socially disadvantaged criteria or meet income criteria designated as high impact areas.

Sustainable Ag Provisions:

Credit policies should enable farmers to make changes in their farming operations and fertilizer usage. Changes in farm practices should be encouraged. FmHA should not be able to change Farm plans to reflect their assertion of estimated costs for chemical inputs. This practice has been reported around the country and needs to be stopped.

County Committee Election Reforms:

The Ag Credit Act established some new provisions enabling FmHA borrowers to serve as elected FmHA County Committee members. Proposed reforms include election by mail at the same time as ASCS elections. Appointment procedures need to be examined as well as FmHA's procedures for notifying FmHA borrowers of their opportunities to run for County Committees. Extensive training at the state or regional level should be provided for all County Committee members. These trainings should be comprehensive about the role and responsibilities of the County Committee member.

Mediation Programs:

The law should require other government agencies to participate in mediation when it is the least cost alternative. This applies to Small Business Administration, FDIC, and Farm Credit System Institutions. The Credit Title should specify the role of mediation in those states where there is not a state certified program to ensure that farmers are receiving appropriate mediation services.

Inventory Land:

The 1990 Credit Title should strengthen existing legislation enabling the purchase of farms classified as "suitable" by family farmers. Currently over 1 million acres is in FmHA inventory. This translates into over 3,500 farms. Since enactment of the 1987 Ag Credit Act, 80% of the land being sold out of inventory has been sold to FmHA-eligible farmers. The 1990 Credit Title needs to preserve the priority and appraisals provision in the 1987 Ag Credit Act. Without this, family sized farmers will be out-bid by others in the re-purchasing of the farms. There needs to be additional outreach efforts to reach farmers or potential farmers to utilize the program. This includes availability of financing and fair appraisals that reflect the productive capacity of the farming operation.

Farmers whose land was in inventory on the date of enactment should receive notices about their rights under the 1987 Agricultural Credit Act. FmHA has taken the position that they had received notice under the Food Security Act and that they did not have to re-notice despite new rights for repurchase under the 1987 law. If the land has already been sold out of inventory or leased, the previous owner should also receive notice with the option to enter into a lease/option for their property.

Conservation Easements:

FmHA inventory land being repurchased or leased by the previous owner should have the option of the conservation easement unless the easement is on land that covers existing wetlands which have not in any of the preceding five years been used as crop or pasture land, and cannot in a typical productive year be so used without a man-made drainage system, unless such drainage system is already in place. The lease or sale price of any land in inventory that includes conservation easements should accurately reflect a decrease in price proportional to the land that is taken out of production.

Appeals System:

The high reversal rate on FmHA appeals is a sign of how badly this appeals system has been needed by FmHA borrowers who have been consistently denied their rights. The National Appeals Board must have the authority to enforce decisions they have overturned with state FmHA officials. Repeated reversals against the same County Supervisor should be recorded in their personnel file and acted upon accordingly.

Retirement Homestead:

The level of farm assets held by farmers nearing retirement makes it critical that federal policies recognize these trends. While the Ag Credit Act provides opportunities for debt restructuring and homestead protection, these provisions have proved to be inadequate for farmers over 60 years of age. Homestead agreements still require rental payments or market value buy-outs of a homeplace. Farmers have worked all their lives to own these farms and many times have paid for them several times over in interest payments. Restructuring agreements often use unrealistic 20 year farming plans for farmers who will not live long enough to carry those plans out.

We recommend that Congress create a special provision in the 1990 Farm Bill to deal with the special situation of elderly farmers. The relative cost of providing services to displaced senior citizen farmers needs to balanced against allowing farmers to stay on their farms.

CONCLUSION

In conclusion, we look forward to working with this Subcommittee to develop a comprehensive Credit Title for the 1990 Farm Bill that initiates new programs while strengthening the programs established in the Agricultural Credit Act of 1987. These proposals need to address overall access to credit, reforms in Farmers Home Administration as well as enforcement of the borrowers' rights provisions applying to the Farm Credit Administration. Thank you for this opportunity to be here and will be more than happy to answer any questions.

Senator CONRAD. Thank you very much. Mr. Severens, welcome. Good to have you here.

STATEMENT OF EUGENE SEVERENS, CENTER FOR RURAL AFFAIRS, WALTHILL, NE; ACCOMPANIED BY JERRY HANSEN, CENTER FOR RURAL AFFAIRS

Mr. SEVERENS. Thank you very much, Mr. Chairman.

INTRODUCTION

With me is Jerry Hansen of the Center for Rural Affairs, who is the principal author of the reforms that are attached to my testimony. In the interest of time, I would like to skip right down to the part of the testimony where it begins what we have called the "Three Big Lessons" of FmHA lending.

THE "THREE BIG LESSONS" OF FMHA LENDING

By way of background, I will simply say that the Center has been involved in monitoring Farmers Home loan programs for over 10 years, and it has involved credit counseling, analysis of data, as well as being fairly active in developing reforms for consideration by congressional committees like this one.

The staff of the Center have reviewed the performance of FmHA lending programs including shelves of reviews and critiques prepared by GAO and the USDA Inspector General's Office over the years. We find that there are three very clear "big lessons" about FmHA farm lending. These lessons, when added to an evolving demographic reality, which I will discuss later, point clearly to the directions that FmHA reforms should take. In fact, if the committee accepts these lessons, we think the general types of reforms now needed follow axiomatically.

The first big lesson is that FmHA's traditional direct FO and OL programs have been the most successful of all FmHA's farm lending programs. Over the decades, these two programs have created thousands and thousands of new farming opportunities *and* historically experienced very low loan loss rates. Unfortunately, this incredible success story currently serves no particular political interest, and it has been completely lost in the last few years' worth of reporting on FmHA problems. We would like to say it now, loud and clear, that these decades-old programs are far and away the most successful of all FmHA's programs from the standpoint of serving both fiscal efficiency and the agency's public purposes.

The second lesson, by contrast, FmHA's emergency loan programs are a dismal failure. This has already been referred to several times by the chairman and others, and so I will not really go into this point. I think it may be important to point out, however, it is not necessarily the emergency loan purposes per se that are at fault in these programs although that does increase the risk, but rather it is the high loan ceilings or for a period of history and time the no loan ceilings that accompanies those programs.

The third lesson, as currently designed, guaranteed lending does nothing to assist beginning farmers; the primary effect has been to bolster the creditworthiness of more established farmers and lenders' portfolios. But GAO and USDA Inspector Generals' reports have shown that nearly all of the guaranteed loans made in the past few years have gone to existing borrowers of a commercial lender. They have not been used either to graduate direct borrowers to commercial credit or to assist new borrowers obtaining commercial loans. As a recently publicized event in Iowa shows, guaranteed loans can be exploited by a lender not only to bolster a bad loan, but to deceive farm-borrowers and precipitate liquidation.

In the 1991 budget proposal for Farmers Home, the administration has proposed some interesting ideas on how to reorient guaranteed lending. We feel that the administration's proposals are a step in the right direction, but fall far short of rectifying inherent problems with guaranteed loans. We would like to discuss this later if there is time.

Added to these three lessons is an important demographic reality. Almost half of the country's farming assets are now held by farmers who will be retiring in the next 10 years. In recent years, most farm assets sold have been acquired by established farmers or investors. This loss of new-entry farming opportunities and the resulting concentration in ownership of farming assets are not inevitable, but effective FmHA lending targeted to the needs of beginning farmers is essential to assure beginning farmer access to land ownership. The transfer of these assets is an historical opportunity and will be one of the most important factors affecting social and economic health of the country's agriculturally based rural communities.

OUR REFORMS

For the next session, we will talk about reforms that we have been working on, and I would like to say that these proposals have been circulated to State and local Farmers Home officials in Nebraska as well as the Nebraska Bankers Association, and we have appreciated the feedback that we have gotten from them, and we had made a number of corrections based on that, and we are looking forward to ongoing dialogs with those groups.

A SEPARATE AND EXPLICIT PROVISIONS FOR BEGINNING FARMERS

One of the first things we think is that there should be a separate and explicit provisions for beginning farmers. I note that Mr. Johnson and Senator Boschwitz and others have mentioned the importance of beginning farmers as a mission of Farmers Home Administration.

We think it is perhaps time now to create separate and explicit provisions for beginning farmers.

SPECIFIC PROVISION FOR PLANNED GRADUATION SUPPORTED BY REQUIRED BORROWER TRAINING AND LOAN ASSESSMENT

The second summary point of our proposals are that there should be specific provision for planned graduation supported by required borrower training and loan assessment. A number of other previous speakers have spoken about graduation, and I think what I heard missing from those discussions was that graduation needs to be accompanied by adequate training. In fact, access to Farmers Home assistance in the beginning should make graduation one of the targets of Farmers Home assistance from the very beginning. If we do not do that, we are going to end up with what we call cold turkey graduation, which is not going to serve any purpose. It is likely to backfire, create more problems than it is intended to solve.

And what we need to do is to have entry processes into Farmers Home assistance that make this part of the goal and have the type of Farmers Home assistance in place, the programmatic content that works toward that goal of graduation and phases into graduation so that graduation does not have to be faced in year 7 as a cold turkey experience.

GUARANTEED LENDING MUST BE STRUCTURALLY REVAMPED TO BRING IT INTO LINE WITH FMHA'S GOALS OF PROVIDING ASSISTANCE TO BEGINNING FARMERS

Third summary point of our proposals is that guaranteed lending must be structurally revamped to bring it into line with FmHA's goals of providing assistance to beginning farmers. We agree with previous testimony about guaranteed lending here at the table. We think that guaranteed lending implies a change in Farmers Home's mission that is not being addressed. Guaranteed lending serves a different type of borrower. It serves banks. It is a different public purpose than the public purpose for which Farmers Home was created, and it is important to recognize that. We have three points under this. First, we think that there should be no reduction in direct lending until guaranteed lending approaches have demonstrated, such as the ones proposed by the administration, have demonstrated that they can reach beginning farmers. Second, we propose that interest assistance be provided with guaranteed loans to beginning farmers. However, this innovation must be very carefully designed or it will not work as past experiences with the FmHA interest buydown program and the joint FmHA farm credit service demonstration project show. Third, we believe that FmHA guarantees equipped with individually tailored interest assistance can be packaged by FmHA and successfully marketed to commercial lenders if it is properly designed. We have included in our proposals some suggestions on ways that could be done. Again, they are some innovations. They need to be carefully considered, and we are open to suggestions on that. Revamping guaranteed lending is, in our opinion, something that would have to be done if the agency is serious about working with beginning farmers. It is inconsistent, we think, for anyone to advocate that they are in favor of beginning farmers and then to turn around and propose using guaranteed lending in their current form. Beginning farmer and guaranteed lending programs simply do not work.

So if we are talking about serving beginning farmers, and we are talking about doing it in anything other than a token way, we have got to be talking about radically changing what we mean by guaranteed lending. I do not think the administration's current proposals come up to that measure. They include some interesting steps, and it is good to see that a dialog can be begun on that point.

THE ADMINISTRATION'S 1991 BUDGET PROPOSAL

The last section of my testimony includes a few remarks about the administration's 1991 budget proposal. Actually, since the record is being kept open for a couple of weeks, we have received additional information since we wrote this testimony. And what we would like to do would be to prepare a written analysis of those and submit them to the committee for consideration.

[Information supplied by Mr. Severens, "The Administrations FmHA Proposals: New Initiatives But No New Opportunities," Information Alert 90-02, dated February 14, 1990, can be found on pp. 164 to 166.]

Senator **Conrad**. That would be enormously useful, and we would appreciate it very much if you would do that.

Mr. **Severens**. OK. Thank you. That ends my testimony. Thank you very much for this opportunity, and if you have any questions, Jerry and I would be glad to help try to provide an answer.

[The prepared statement, draft, a Legislative Proposal to Reform FmHA Farm Lending Programs, and the Administration's FmHA Proposals: New Initiatives But No New Opportunities of Mr. Severens follow:]

Testimony of Gene Severens and Jerry Hansen
Center for Rural Affairs
Walthill, Nebraska

Before the
U.S. Senate Committee on Agriculture, Nutrition and Forestry
Subcommittee on Agricultural Credit

February 8, 1990
Washington, D.C.

Mr. Chairman, thank you for this opportunity to provide testimony on FmHA farm program loans. My name is Gene Severens; accompanying me is Jerry Hansen. We represent the Center for Rural Affairs, which is an unaffiliated, non-profit organization founded in 1973 and located in Walthill, Nebraska. The Center staff has monitored and analyzed federal farm credit policies for the past ten years -- a period of enormous stress in U.S. agriculture and at FmHA.

In 1985 and 1987 Congress passed major legislation that has in many respects been effective in dealing with that stress. The 1985 credit title dealt with the needs of existing farmers by appropriating guaranteed loan funds which allowed commercial lenders to stick with their existing farm borrowers through some very tough times. Similarly, the FmHA component of the 1987 Act dealt almost exclusively with stabilizing existing borrowers.

We believe that it is now time to thoroughly re-examine FmHA's farm loan programs, to cull the poor-performing programs, and to build on proven programs using appropriate innovations to enhance their effectiveness. In the following sections, we will:

- -- review the three historical lessons of FmHA lending,
- -- summarize our proposals for reform, and finally,
- -- briefly analyze the Administration's recent 1991 budget proposal for FmHA.

The "Three Big Lessons" of FmHA Lending

We have reviewed the performance of FmHA lending programs, including shelves of reviews and critiques prepared by GAO and the USDA Inspector General's office. We find there are three very clear "Big Lessons" about FmHA farm lending. These lessons, when added to an evolving demographic reality, which I will discuss later, point clearly to the direction that FmHA reforms should take. In fact, if the Committee accepts these lessons, we think the general types of reforms now needed follow axiomatically.

1. **FmHA's traditional direct FO and OL programs have been the most successful of all FmHA's farm lending programs.** Over the decades, these two programs have created thousands and thousands of new farming opportunities and experienced very low loan loss rates. Unfortunately, this incredible success story currently serves no particular political

interest, and it has been completely lost in the last few years' worth of reporting on FmHA's problems. We want to say it now, loud and clear, that these decades-old programs are far and away the most successful of all FmHA's programs from the standpoint of serving both fiscal efficiency and the agency's public purposes.

2. By contrast, **FmHA's emergency loan programs are a dismal failure.** These largely untargeted programs have, beginning in the mid-1970's, absorbed increasingly large proportions of FmHA's total loan appropriations and created the bulk of the loan losses experienced by FmHA in the 1980's. These costs were incurred while serving the questionable premise that every farm in America deserved federal assitance when it experienced economic or natural disasters. Criticisms of abuses in FmHA's emergency lending programs have been largely deserved, but unfortunately, these criticisms have been indiscriminate and discredited, by implication, all FmHA farm programs instead of just the emergency programs.

3. As currently designed, **guaranteed lending does nothing to assist beginning farmers;** the primary effect has been to bolster the creditworthiness of more established farmers and lenders' portfolios. Both GAO and USDA Inspector General's reports have shown that nearly all of the guaranteed loans made in the past few years have gone to existing borrowers of a commercial lender. They have not been used to either to graduate direct borrowers to commercial credit or to assist new borrowers obtain commercial loans. As a recently publicized event in Iowa shows, guaranteed loans can be exploited by a lender not only to bolster a bad loan, but to deceive farm-borrowers and precipitate liquidation.

In the 1991 budget proposal for FmHA, the Administration has proposed some interesting ideas on how to re-orient guaranteed lending. We feel that the Administration's proposals are a step in the right direction, but fall short of rectifying the inherent problems. We'll discuss these below.

A demographic reality: Almost half of the country's farm assets are held by farmers who will be retiring in the next ten years. In recent years, most farm assets sold have been acquired by established farmers or investors. This loss of new-entry farmers and the resulting concentration in ownership of farming assets are not inevitable, but effective FmHA lending targeted to the needs of beginning farmers is essential to assure beginning farmer access to land ownership. The transfer of these assets is an historical opportunity and will be one of the most important factors affecting social and economic health of the country's agriculturally based rural communities.

Our Reforms

With these lessons in mind, we think that it is time to: re-evaluate FmHA's mission; develop programs that serve that mission; and design new tools that are both programmatically effective and fiscally responsible. We have attached detailed proposals to this testimony and hope these are useful to the Committee. For purposes of this testimony I would like to summarize the philosophy behind the proposals and their main features.

First, there should be a **separate and explicit provisions for beginning farmers.** Some new tools which support such provisions include:

-- "Downpayment loans" which would provide a new mechanism by which FmHA and a beginning farmer would jointly come up with the downpayment for farmland purchase with the main loan being financed by a retiring seller or commercial lender. This approach is far more efficient that current FO lending because it leverages the same appropriated amount to roughly three times as many borrowers.

-- An annual per borrower "subsidy assistance cap" which would be applied to both direct and guaranteed loans. The effect of such a cap would be to concentrate assistance to beginning farmers whose credit needs typically are (and should be) smaller.

-- All emergency lending should either be made a subpart of the OL program (thereby better assuring that family-size farm eligibility requirements are rigorously applied and allowing administrative streamlining of FmHA programs) or stricter provisions, especially lower loan ceilings, need to be added to the EM program.

Second, there should be specific provision for **planned graduation** supported by required **borrower training and loan assessment.** Loan assessment should be conducted on each new loan by outside credit counselling services. The analysis would specifically ask: "Can FmHA credit help this borrower acheive this operation's goal within the terms and timeframe allowed by FmHA?"

The timeframe of this analysis would presume and plan for graduation to commercial credit. Graduation requirements should be flexible enough to allow for a broad economic downturn or other circumstances beyond the borrowers' control, but firm enough to keep all borrowers attuned to meeting loan graduation goals. Borrower incentives for early graduation could also be used to promote graduation.

Borrowing training would require each borrower to have an understanding of basic farm financial management, and completion of training would be a prerequisite of loan making. While the borrower training and loan assessment procedures represent a new cost, we believe that increased management skills better assures repayment of FmHA loans, and when combined with planned graduation, the net effect will be reduced costs through more orderly loan repayments.

Third, **guaranteed lending must be structurally revamped** to bring it into line with FmHA goals of providing assistance to beginning farmers. First, this means there should be no reduction of direct lending until guaranteed lending approaches have demonstrated that they can reach beginning farmers. Second, we propose that interest assistance be provided with guaranteed loans to beginning farmers. This innovation must be very carefully designed or it won't work as past experience with the FmHA "interest buy-down" program and the joint FmHA-FCS "demonstration program" show. Third, we believe that FmHA guarantees, equipped with individually tailored interest assistance, can be packaged by FmHA and successfully offered to commercial lenders.

The Administration's 1991 Budget Proposal

At the time we prepared this testimony we did not have access to all of the Administration's FmHA proposals. Based on what we have seen, we think it includes two steps in the right direction. Unfortunately, the steps are very tentative, and until we have more information, our analysis is necessarily limited.

The first step calls for graduation after seven years. As mention above, we think it is time for better graduation provisions. But graduation must be a planned event not a "cold turkey" graduation. This is why our graduation proposal is accompanied by provisions for loan assessment and required borrower training.

The second step calls for "subsidized guarantees." This, also, is similar to proposals our organization has made. But given the failure of previous subsidized guaranteed programs, as mentioned above, we are anxious to see how the Administration plans to avoid these previous experiment's shortcomings and prevent the approach from becoming a token beginning farmer program.

As we learn more about the Administration's plans, we would be happy to provide both the Committee and the Administration with our analysis.

Mr. Chairman, thank you for this opportunity to testify.

DRAFT

A LEGISLATIVE PROPOSAL TO REFORM FMHA FARM LENDING PROGRAMS

Introduction

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DRAFT

Introduction

The following proposals for reform of FmHA's farm loan programs are the result of 10 years of monitoring FmHA's policies and practices and assisting FmHA applicants and borrowers. The bulk of the proposals is designed to increase the number of entry opportunities FmHA provides to beginning farmers through appropriations earmarked for separate beginning farmer lending. Many of the proposals in this group would, however, also be applicable to all farmer program lending. Several other proposals would address problems in other areas of FmHA lending. The entire reform agenda is designed to make the agency's farm lending of more assistance to borrowers in establishing viable farming opoerations in a manner consistant with sound fiscal policies.

In the financial crisis of the 1980s Congress focused FmHA attention on the problems of existing farmers. The 1985 Credit Title vastly increased FmHA's guaranteed lending authority, and that authority permitted commercial and cooperative lenders to stay with thousands of their already established farm borrowers. The Agricultural Credit Act of 1987 similarly directed assistance to established farmers who were already in debt to FmHA and the Farm Credit System. These efforts are ongoing, but as the effects of the financial crisis diminish it is time to focus on the needs of beginning farmers. To do this effectively, there is a need for FmHA lending programs designed for and limited to beginning farmers.

Background

Originally, FmHA's primary public purpose was to secure farming opportunities for family-size farms. This decades old purpose has been achieved through two main programs: Direct (insured) Farm Ownership (FO) loans for purchasing farmland and Operating Loans (OL) for production credit. These direct lending programs have been strictly limited to family-size farmers who could not obtain credit elsewhere.

FmHA's main departures from these basic programs--guaranteed and emergency lending--have proven to be of little use in advancing this purpose. And, especially with emergency lending, they have proven to be fiscally irresponsible. Guaranteed lending has been gradually replacing direct lending in the FO and OL programs for several years. As an emergency response to the farm crisis of the early and mid-1980s this was justified, but as a permanent attempt to provide farming opportunities current guaranteed lending is clearly inadequate. A recent USDA Office of Inspector General audit found that 99% of the 15,585 guaranteed farmer program loans made between October 1, 1985, and June 7, 1987 were made to farmers who were already established borrowers of commercial or cooperative lenders. The other 1% went to FmHA direct loan borrowers shifting to FmHA guaranteed loans. In spite of several legislative and administrative attempts to make guaranteed lending more responsive to the needs of beginning farmers and more useful for FmHA borrower graduation to commercial credit, guaranteed loans as they now exist remain of little use to beginning farmers.

If guaranteed lending is to play a constructive part in furthering FmHA's time proven and legislatively established mission, it must be carefully recrafted. As a means to assist graduation from direct lending, guaranteed loans can be a planned and fiscally sound part of FmHA's farmer lending programs. For many beginning farmers they can also be made to be valuable tools of farming entry.

Emergency lending has already come close to being eliminated through the weight of its own failures. As shown in the following chart both the ongoing Emergency Disaster (EM) Program and the already discontinued Economic Emergency (EE) Program have contributed disproportionately to FmHA's loan losses and to the financial problems of their recipients.

Chart 1

	Direct FO & OL Loans	Direct EM & EE Loans
Loan dollars outstanding	$12,100,004,000	$11,184,283,000
Delinquent dollars outstanding	$ 2,492,526,000	$ 6,789,556,000
Percentage of dollars outstanding delinquent	21%	61%

Congress has already recognized the problems with emergency lending by discontinuing EE lending, limiting EM lending to actual loss loans of $500,000 or less, and by placing little emphasis on EM lending in the 1988 and 1989 drought relief legislation. In addition, in spite of substantial appropriations for EM loans in fiscal years 1988 and 1989 (a total of $1,178,000,000) only $30 million in EM loans were made in fiscal year 1988 and $73 million in fiscal 1989. In practice new emergency lending has already come to play an almost negligible role at FmHA. Whether emergency lending is to play a significant role in the future will be decided by Congress as the need arises, but it seems obvious that this lending should not occur under the terms used earlier.

While not exemplary, the loan delinquencies in the direct FO and OL lending programs are relatively small, especially in light of the financial crisis in U.S. agriculture in the 1980s. These direct programs are the proven core of FmHA farm lending. Without them there is little reason for FmHA involvement in farm lending. FmHA's direct lending can be improved by placing greater emphasis on upgrading borrower management skills, and what is now the limited resource component of direct lending can be better targeted to assure that this special assistance goes to those borrowers with the greatest needs. The following proposals are designed to achieve those ends.

DRAFT
Proposals to Reform FmHA Farm Lending Programs
Summary
October 1989

Purpose: To learn from the lessons of FmHA lending in the 1970s and 1980s and to restore FmHA's basic mission of maintaining entry opportunities in agriculture by provding modest and temporary credit assistance to efficient family-size farms. The reforms would refine and bolster current programs and procedures which support that goal, and they would reduce or eliminate those programs and procedures which have proven to neither advance that goal nor protect the government's interests. The proposals would provide the maximum number of farming opportunities within likely fiscal restraints, with emphasis on helping to establish successful farming operations which are able to quickly repay FmHA credit and graduate to commercial credit.

I. Separate Beginning Farm Loan Programs

Compared to the general farming population, there are, at any particular time, relatively few people who want to start farming in the succeeding year or two. Over time these people could represent a strong constitutency, but they are never able to collectively influence FmHA lending priorities or legislation. Because they lack a strong voice, their needs generally have not been well served in the competition for scarce FmHA resource. Assisting entry farmers should be FmHA's most important job. To do this effectively there is a need for separate program and funds. Without these separate authorities beginning farmers will inevitably be lost in the competitive shuffle at FmHA.

Earmarking funds for specific lending programs is relatively easy, but making sure that those funds are used in ways that best assist entry farmers in a fiscally sound manner is much more difficult. The proposals that follow are designed to address that task. They would, whenever possible, use scarce FmHA funds to leverage funds from other sources. They would provide a variety of types and amounts of FmHA assistance to meet the needs of beginning farmers with a wide range of abilities and financial situations. They emphasize that FmHA assistance can and should be temporary because it allows and encourages the financial and management growth needed to graduate to commercial credit. And last, but very importantly, the proposals are designed to produce borrowers who can repay their FmHA debt and thereby protect the interests of the government.

II. Market Placement of FmHA Loans

Market placement of FmHA loans would allow the use of guarantees whenever possible, and it would assure that FmHA assistance was tailored to each borrower's situation and needs. FmHA assistance should as quickly as possible lead to viable farming operation able to get commercial credit. Direct and guaranteed loans should be the steps that lead to commercial viability, and the stairway they comprise should be continuous and designed to allow borrowers to enter at the appropriate level. With market placement the financial market would determine where borrowers started on that stairway. The steps from direct to guaranteed credit and then to commercial credit would no longer be barriers. Many new FmHA borrowers could bypass the direct level and immediately get into the FmHA system at the guaranteed level.

FmHA eligible farmers have a variety of types and sizes of operations and come with a variety of strengths and needs. Because FmHA eligibility encompasses a wide range of financial and managerial situations, there is no one type of loan or degree of assistance that is appropriate for all eligible borrowers. Current FmHA legislation partially recognizes this range by providing limited resource and regular interest rate direct loans and guarantees for commercial loans. The current structure is inadequate, however, because of gaps that exist in the repayment requirements for the loans mentioned. For instance there is a 4.5% interest difference between limited resource and regular interest rate farm ownership loans. A gap nearly as large now exists between regular direct and guaranteed FOs. These gaps prevent the kind of tailored FmHA assistance that is in the best interests of both borrowers and the government.

With tailored assistance FmHA borrower could be placed with commercial lenders much sooner because repayment gaps would no longer exist and because most new loans would be made available with a guaranteed to commercial lenders. Market placement would have the following components.

1. Applicants wishing FmHA assistance for the first time would contact FmHA and go through the normal County Committee eligibility screening. Those found eligible would proceed to the loan assessment process described in section VII of this proposal.

2. In loan assessment the farming plans and financial situations of borrowers would be evaluated in accordance with standards prescribed in legislation and established in regulation by the Secretary. Based on standards established by the Secretary, applicants would be divided into two groups--those whose situations appeared to be compatable with guaranteed loans and those who needed more intense FmHA direct assistance prior to advancing to guaranteed loans. Applicants who needed direct assistance would be handled as they are under current regulations and legislation as modified by proposals made here.

3. Applicants with potential for guaranteed loans would then provide assessment personnel with all the information necessary to complete guaranteed loan packets. These packets would contain applicant cash flows, balance sheets, guaranteed loan documents and statements of the amount of interest assistance that would be needed for applicants to cash flow guaranteed loans.

4. With this approach the interest payment on a guaranteed loan would be a combination of the amount an applicant's cash flow would allow in interest payments plus a residual amount that FmHA would contribute in the form of interest assistance. The total interest rate would be the average interest rate charged by commercial and cooperative lenders for similar loans in the area an applicant was located. The packets developed in assessment would be evaluated and verified by FmHA county office personnel.

5. The guaranteed loan packet would then be circulated to area lenders with a solicitation to "bid" on the packet. The packet would be an offer from FmHA to provide a 90% guarantee on the proposed loan.

6. The packets would not include borrowers' names, but the applicants would be available for interviews with lenders and for purposes of further data verification by lenders. Lenders with an interest in making the proposed loan would respond by bidding on the loan. A bid would be an offer to make the loan at a specified interest rate. The rate could be no larger than the area established average for the type of loan involved or it could be a lower rate where lenders were especially interested in getting the new business the loan represented. In some and perhaps many cases this bidding would save government funds because the amount of FmHA interest assistance required would be less on loans made at rates below area established average rates.

7. Proposed guaranteed loans that were not bid on in this process would immediately be funded as direct loans from FmHA. The combination of completed loan applications plus interest assistance plus 90% guarnatees should work to assure that the number of loans not bid on by commercial lenders would be relatively small.

8. FmHA should be given the discretionary authority to require cash flow repayment margins of not larger than 105% on all guaranteed farmer program loans. The current administratively adopted 110% requirement is excessive and should not be necessary if FmHA were to devote more time to verifying cash flow and asset information.

For the interest assistance beginning farmer guarantees proposed here, the concept of borrower provided cash flow margins does not work well. Imposition of these margins could have two alternative effects. First, such margins could exclude large numbers of applicants from guaranteed loans because of cash flow requirements, and thereby increase the number who would need direct loans. Or second, the margins could simply increase the amount of interest assistance required from FmHA to bring cash flows to particular margin positions.

For the market placed guaranteed loans, two alternatives are suggested to the currently used cash flow margins. First the cash flow requirements could simply be placed at 100%. Careful verification of cash flows and assets when coupled with safeguards like crop insurance should make 100% cash flows adequate to protect the government's interests. Alternatively, the margin requirements could come in the form of additional interest assistance that would be a conditional commitment from FmHA that would be used only when necessary. This conditional commitment would be operative only when cash flow fell below full repayment (100%) and when such cash flow shortfalls were for reasons beyond borrower control.

9. The market placement approach would rely on more fully using guaranteed fund appropriations that have been unused in recent years. There have been unused guaranteed FO and OL funds that could have been used had the market approach been in place. This approach would also result in better use of direct appropriations as more applicants were place immediately into

the guaranteed system. Interest assistance could be provided for several fiscal years from funds appropriated in the 1985 Farm Bill. These interest assistance funds have largely been unused, but their availability was extended in the Ag Credt Act of 1987.

III. Capping Per Borrower Cost of FmHA Assistance

Under current legislation the cost to the government of FmHA assistance is a factor of both loan size and of the interest rate charged. At any given interest rate the larger the loan the larger the amount of government assistance and the larger the governments costs. For instance, it costs the government $4,500 for a $100,000 limited resource FO loan (9 1/2% cost to the government of funds less 5% interest charged equals 4 1/2% times $100,000) and $9,000 for a $200,000 LRFO (9 1/2 - 5 = 4 1/2 times $200,000). Benefits for operating loan borrowers work similarly.

This system assumes that the larger the land purchase or the larger or more capital intensive the operation, the more value it has from the government's standpoint. FmHA is charged with helping to provide farming opportunities, and those opportunities do and should come in many sizes and types. These diverse operations all represent farming opportunities that should have equal value for promoting FmHA's mission. Because they are of equal value the operations should, within limits, be able to receive the same amounts of FmHA assistance when it is needed.

This proposal would provide limits on the maximum per borrower per year cost to the government of FmHA farmer program assistance, and it would provide equalized assistance to borrowers. The limits suggested would apply across the board on beginning farmer program loans from smaller direct loans for traditional LR borrowers to interest subsidized guaranteed loans (see section II) for more established borrowers.

For FO loans this limit is suggested as $4,000 per borrower per year for a maximum of $40,000 per borrower and for OLs the limit suggested is $3,000 per year per borrower for a maximum of $21,000. The limits could apply either to consecutive or nonconsecutive years. In the direct FO example above the $100,000 loan interest rate would be not less than 5 1/2% (9 1/2% - 5 1/2% = 4 1/2% times $100,000 equals $4,000). For the $200,000 loan the interest rate would be not less than 7 1/2% (9 1/2% - 7 1/2% equals 2% times $200,000 equals $4,000). The interest rates in these examples could be as high as the cost to the government rate depending on borrower ability to repay (cashflow).

For interest subsidized guaranteed loans the system would work similarly. For instance, a $100,000 guaranteed commercial OL made at 12% interest would result in borrower paid interest of not less than 8%. Again, repayment ability could result in assistance of less than $4,000 per year. In fact borrowers with strong cashflows would receive only the guarantee and no interest assistance.

In calculating cost to the government only interest forgone on direct loans or interest assistance provided on guaranteed loans would be considered. Potential losses based on previous lending would not be considered. Borrowers would always be required to repay all borrowed principal.

As noted earlier, this approach to providing FmHA assistance would recognize that each farming opportunity provided is of equal value, but also that there are a wide variety of farming operations that need and deserve FmHA assistance. More disadvantaged borrowers and those just starting to farm generally should have smaller credit needs. For these borrowers assistance would be concentrated in smaller operations and provide greater opportunities to establish viable farming operations. More established borrowers with larger credit needs could receive as much assistance but it would be spread over larger loan sizes. Within the time frames prescribed there would be opportunities to stepup loan sizes, especially for operating loans. This would allow flexibility to expand during the periods of FmHA eligibility.

Where conditions beyond borrower control prevented full repayment on any type of affected loan, the time and assistance maximums could be extended to allow reamortization and rescheduling, but it is suggested that the time periods be extended no more than 2 years for operating loans and 3 years for farm ownership loans. Where resultant assistance exceeded the suggested loan program maximums (OL-$21,000 and FO-$40,000), it is suggested that the excess be scheduled into payments due to the government. Borrowers whose financial situations changed, either for the better or worse, during the periods of assistance could have the amount of assistance either lower or raised during the remainder of their loan periods.

Borrowers already endebted for FOs and Soil and Water loans would be excluded from these requirements on existing loans. Current OL borrowers would be excluded from the requirements on existing loans and on subsequent loans made during the three years following enactment, but OLs made to these borrowers after three years would be subject to these limitations on new loans. There are no new EE loans being made so these borrowers would be affected only if they applied for new FmHA financing under other programs. Current EM borrowers would be handled in the same way as EE borrowers. However, another provision of these proposals would do away with EM lending as a separate program. Under the EM proposal any new EM lending would be through and under the terms of the OL program and would therefore be affected by this proposal.

IV. Farm Ownership Loan Program. This section would expand the availability of the direct FO program by leveraging private financing with limited FmHA funds. FmHA would make "down payment" loans of 30% of the purchase price of farm real estate parcels while FmHA-eligible buyers would contribute an additional 10% from their own savings. Private land sellers could elect to receive the resulting 40% down and carry the remaining principal in mortgage agreements or the remaining principal could be financed with commercial or cooperative lenders. The FmHA loans would be for 10 year periods at no interest, but would be considerably less expensive per borrower to the government than the now typical 100% loans made at the limited resource interest rate. Because the recipients of down payment loans wuld be required to provide 10% of the purchase price, they would be better off financially than have most limited resource borrowers in the past. There would therefore be no limited resource component to the down payment loan program. Instead, the 25% quota already set in statute for FOs would be met with loans made through the traditional FO program.

Farmers likely to retire in the next 10 years own nearly half of all U.S. farming assets, and this approach would help to prevent the concentration of those assets into operations of already established farm and nonfarm investors. Direct FO loan appropriations used for down payment loans would serve over 3 times as many borrowers as does the current FO approach.

Current FO loans are often used to refinance the existing debt of established farmers. While this use of FO funds has and can serve a useful purpose, they do not provide new farming opportunities. This proposal would reserve 50% of the FO appropriations for down payment loans and therefore for new opportunities. The other 50% of the appropriation would be used for conventional FOs with one-half of that amount being used for limited resource loans to more disadvantaged borrowers. Each $100 million in FO appropriations for down payment loans is equivalent to 3,333 FOs if the average value of land purchased were $100,000. This contrasts with the 1000 such loans provided with conventional FO loans for 100% of the purchase price.

Chart 2

Example of FmHA borrower debt and equity position on a 10 year down payment loan

Property purchase price--$100,000
1st mortgage interest rate--11%
Buyer down payment--$10,000
FmHA down payment loan--$30,000
Yearly payment to FmHA--$3,000
Non-FmHA financing--30 year amortization with 10 year balloon

Yr.	FmHA Payment Prin. only	Interest on 1st Mort.	Principal on 1st Mort.	Total on 1st Mort.	Total Yrly Payments	Total Debt Remaining	Borrower Equity in Property
1	$3,000	$6,600.00	$301.48	$6,901.48	$9,901.48	$86,698.52	13.3%
2	"	6,566.84	334.64	"	"	83,363.88	16.6
3	"	6,530.03	371.45	"	"	79,992.43	20.0
4	"	6,489.17	412.31	"	"	76,580.12	23.4
5	"	6,443.81	457.67	"	"	73,122.45	26.9
6	"	6,393.47	508.01	"	"	69,614.44	30.4
7	"	6,337.59	563.89	"	"	66,050.55	33.9
8	"	6,275.56	625.92	"	"	62,424.63	37.6
9	"	6,206.71	694.77	"	"	58,729.86	41.3
10	"	6,130.28	771.20	"	"	54,958.66	45.0

Borrower equity position at the original purchase price would be 45%. This level of equity meets or exceeds most borrower equity requirements for commercial real estate loans.

This approach to FO lending could be modified in two ways to make the loans more widely available. First, where commercial lenders provided 60% first mortgage financing, that portion of the loans could carry an FmHA 90% guarantee without interest assistance. In this case interest assistance would be provided on the direct loan portion of the land purchase price. Alternatively, the 90% of the purchase price not covered by borrower provided down payment could receive a 90% FmHA guarantee. With this approach interest assistance, where it was needed, would be provided in the manner suggested in Section II (Market Placement) of this proposal.

V. Operating Loan Program. The current OL program provides annual operating expense loans which are made and repaid during each production year. For these loans the standard of borrower success is full repayment of principal and interest and, although financial progress may be an unstated goal, there is no mechanism for encouraging progress nor standard for measuring it. The approach proposed here for OLs would provide this mechanism and this standard. In addition, the multiple year approach recommended for annual operating expense loans--loans made in one fiscal year and repaid over several years--would diminish the yearly budget effects of OLs. Currently, every dollar used for direct OLs is counted as a budget outlay in the fiscal year in which the loans are made, whether these loans are repaid in that or a subsequent fiscal year. This proposal would provide the anticipated operating credit requirements of borrowers during the periods when the need for FmHA assistance is anticipated and result in those needs being met with funds from one fiscal year's budget.

The scheduled payments for annual operating expense loans would be interest plus enough principal to reduce indebtedness by 40% during the term of the loans. Longer term OLs would be made to more disadvantaged borrowers under a new limited resource borrower definition described later in this proposal, and the interest assistance described in section II would also be available when needed. At the end of the loan term the remaining principal would be due either through personal repayment, guaranteed FmHA OLs with commercial lenders, or commercial credit.

There would be rigorous initial feasibility testing which would be an integral part of the borrower training and loan assessment provisions described in section VII of this proposal. If delinquencies occurred, there would be retesting of operational feasibility and reassessment of operational plans to address the causes of the delinquency. This problem assessment should in most cases be done in conjunction with loan servicing. Although for fixed terms, the loans would be callable based on carefully defined performance criteria which the Secretary would be required to publish in regulations. Performance failure would be limited to fraud, waste, gross mismanagement, and failure to make scheduled payments.

If multi-year annual operating loans are thought to be unworkable for budgetary or repayment reasons, an alternative approach could be adopted which incorporated it major benefit. This benefit--gradual increase in the percentage of operating funds provided by borrowers--could be achieved as described below. This approach would again involve multi-year planning to reduce dependence on FmHA assistance. Planned borrowing would include the goal of graduation to guaranteed or commercial credit for direct borrowers. For guaranteed OL borrowers similar planning would project the end of need for FmHA guarantees.

For a borrower who started with a direct loan this would mean projecting an increase of borrower provided operating funds from (perhaps) 0 to 20% during the period of the plan. The exact percentage change would vary somewhat regionally, but would be that change necessary to advance to guaranteed loan eligibility. Borrowers would be expected to repay annual operating loans each year of the plan, but in addition in each subsequent year they would also be expected to increase the percentage of funds they provided for operating purposes. This approach would allow operational flexibility (to reduce or increase size) while still progressing toward a higher percentage of borrower generated operating funds. Progress for guaranteed borrowers would be similarly planned and encouraged.

This approach would also incorporate flexibility in dealing with adverse conditions beyond borrower control. With this flexibility, borrower inability to meet the yearly increases in borrower generated operating funds or make full annual repayment would have two results. The first would be a loan reassessment based on the procedure outlined in section VII of this proposal. Reassessment would look at the reasons for repayment problems and make recommendations for correcting the problems. Second, where problems were correctable, borrower loans would be rescheduled and a new borrowing plan established.

As with the multi-year operating loans, this approach is designed to facilitate and plan for an end to borrower need for FmHA assistance. To do this both FmHA and its borowers would from initial loan making be aware of and attune to the need to progress toward commercial credit eligibility.

VI. Borrower Graduation. This section would create a more formal process for graduating FmHA borrowers to commercial credit. FmHA lending has always anticipated graduation to commercial credit for the following reasons: (1) it signals the end of FmHA's temporary assistance and the creation of a commercially viable farm operation; (2) it restores lending funds to FmHA's revolving loan fund so that new applicants' loans can be funded; and (3) it assures that FmHA is not competing with private lending sources. Neither law nor regulation sets explicit standards or goals for graduation. In theory at least, the minute a borrower can get commercial credit, he or she must graduate. The lack of standards, goals and the unplanned nature of the current graduation approach have weakened its value and decreased its use. To improve this situation, graduation should be planned at the beginning of each new FmHA loan as a part of the borrower training and loan assessment process described above. These standards should be flexible enough to allow for an economic downturn, weather-related disasters, and other circumstances beyond a borrower's control, but firm enough to keep all parties attuned to meeting loan graduation goals. The regular loan assessment would be designed to plan for and lead to graduation. Problem assessment would attempt to correct problems and get operations back on the road to graduation.

VII. Borrower Training and Loan Assessment. This section of the proposal would increase the quality and amount of financial management training and assistance received by FmHA borrowers. Borrower training and loan assessment would be part of all FmHA farm lending. This would not only assist borrowers, it would also help to protect the government's interests. FmHA's traditional mechanism for supervised credit has not worked well in recent years for two reasons. First, the 1970s saw a dramatic expansion of FmHA's loan programs which resulted in little if any time for FmHA employees to provide borrower supervision. Second, the 1970's "go-go" lending was based on the idea that land values, and therefore borrower equity, would increase indefinitely and that FmHA loans were therefore adequately protected. The emergency lending programs imposed this mentality on FmHA, and as cash flow and management were seen as less important, credit supervision tended to deteriorate to collateral supervision.

The borrower training and loan assessment component of this proposal recognizes this failure by requiring that FmHA contract with outside credit counselling services to provide borrower training and loan analysis. In most, if not all cases, these services should be available through community colleges, the extension service, state departments of agriculture, or non-profit organizations. The analysis would be operation specific, define operation goals, and specfcially ask "can FmHA credit help this borrower achieve these goals within a reasonable timeframe?" The process would involve the already existing annual reviews to assess progress. When farm plan repayment goals were not met and delinquencies occurred, the contracting entities would provide problem assessment to determine the cause of the problems and to recommend corrective actions. All borrowers would also be required to participate in a separate borrower training course designed to familiarize them with the various facets of financial management associated with commercial farming.

In the case of some limited resource (LR) borrowers additional management assistance would be required. The need for this LR assistance would be based on an applicant's management abilities, would be determined by FmHA County Committees during basic eligibility determination and would be in addition to the management assistance provided in the regular loan assessment and borrower training. The need for special management assistance is difficult to objectify and should be based on the collective judgement of committee members who should by definition be familiar with the agricultural conditions and practices in the counties where the loans are made.

In connection with these new areas of emphasis, the Secretary would be required to develop and publish in proposed regulation the overall guidelines and curriculum for the borrower training and loan assessment and to develop new loan documents which better fit the financial management needs of commercial farms and commercial lenders.

VIII. Emergency lending. This section of the proposal would eliminate emergency lending as a separate program but would retain limited emergency lending authority through the OL program. The Economic Emergency program has been inactive for a number of years and should be officially discontinued.

FmHA's farm lending has received extensive criticism in recent months because of the agency's large loan losses. The criticism lumps large farm emergency loans with family-size FO and OL loans. Even the most elementary analysis would show that FmHA family farm borrowers have proven to be among the least risky of all FmHA's borrowers. The big farm program losses are not in the family farm-targeted FO and OL programs but in FmHA's more open-ended emergency loan programs. Loans in the FO program in particular have been very solid. In fiscal year 1988 over half (57%) of the outstanding loan principal in FmHA's big farmer EM loan program was delinquent ($4.8 out of $8.4 billion). Losses are similarly large in the EE program. In contrast, only 8% of the outstanding FO principal was delinquent ($600 million out of $7.3 billion). Both of the emergency programs have in the past been characterized by high (or no) individual loan ceilings and no family-size farm targeting. While Congress in 1985 did place a family-size requirement on the EM program, these two largely untargeted programs have resulted in massive agency losses and little assistance to their borrowers. They are in large part responsible for FmHA's current disrepute. This proposal would place limited natural disaster lending authority in a national reserve to be lent through and under the terms of the revised OL program. Widespread natural disasters would be addressed on a case-by-case basis by Congress as they are now.

If elimination of the EM program is seen as too drastic a change, it is recommended that the EM appropriation be reduced to a size in line with actual lending in recent years.

IX. Recommended Appropriation Levels

Historically, providing entry farming opportunities has been FmHA's most important role. Credit assistance that is both targeted and limited has over the years provided beginning farmers with the temporary handup they needed. As farming has become more capital intensive this assistance has become even more important. But in the last 10 to 15 years the needs of beginning farmers have tended to be forgotten in the competition for FmHA's scarce resources. If FmHA is to have effective and accessible lending for beginning farmers, there is a need for special programs and earmarked appropriations. Without these normal competition for FmHA's attention and funds will in far too many situations greatly diminish FmHA's ability to provide entry opportunities.

Recent GAO and USDA Office of Inspector General reports illustrate this tendency. The reports show that between 98 and 99% of FmHA farmer program loan guarantees made from October 1985 to June 1987 were made to farmes who were already borrowers of commercial lenders. The rest of the guarantees went to FmHA direct loan borrowers shifting to guaranteed loans. This record shows that guaranteed loans, as they are currently constituted, have served neither to help direct loan borrowers graduate to commercial credit nor to serve as beginning farmer loans. Similarly, the provisions of the Agricultural Credit Act of 1987 focused mainly on the debt restructuring needs of existing FmHA borrowers.

Both the 1985 Farm Bill appropriations for guaranteed loans and the 1987 Act debt restructuring provisions provided needed assistance to existing farmers, but their beginning farmer effects were minimal. Only special programs will do that.

Chart 3, below, contains the actual FO, OL and EM appropriations for Fiscal Year 1989 and the appropriations levels recommended for these loan programs for Fiscal Years 1991-93. The levels recommended are designed to allow implementation of the lending program reforms suggested in the proposals which precede this section.

Overall the direct appropriations would be slightly decreased from FY 1989 but would still provide funds earmarked for beginning farmer FO and OL loans. This is possible because the EM appropriation would be eliminated or alternatively lowered to an amount nearer actual EM lending in recent years. While the overall guaranteed appropriation levels are significantly lower than under the 1985 Farm Bill, they too include funds earmarked for beginning farmers. That is possible because there have been large amounts of unused guaranteed OL funds in recent years. The chart also includes the estimated costs of providing borrower training and assessment for new FmHA borrowers suggested in section VII.

CHART 3

FmHA FO, OL, and EM Appropriations (in $1,000s)

Fiscal Year	Direct* OL	Guar OL	Total OL	Direct FO	Guar FO	Total FO
1989 (actual)	$ 900,000	$2,300,000	$3,200,000	$ 95,000	$474,000	$ 569,000
1991-93 (proposed)	1,300,000	1,500,000	2,800,000	400,000	600,000	1,000,000

Fiscal Year	EM**	Total Direct (FO,OL,EM)	Total Guar. (FO,OL)	Total Guar. and Direct (FO,OL,EM)
1989 (actual)	$600,000	$1,595.000	$2,774,000	$4,369,000
1991-93 (proposed)	- 0	1,500,000	2,100,000	3,600,000

These appropriation levels would reduce overall direct and guaranteed funding, leave sufficient funds to meet the needs of existing borrowers and more established farmers, and still earmark enough direct and guaranteed funds for a significant beginning farmer effort through FmHA.

Proposed appropriations earmarked for beginning farmer loans for FY 1991-93:

Direct OLs: $400,000,000
Guar. OLs: $500,000,000
Direct FOs: $325,000,000***
Guar. FOs: $325,000,000
Total: $1,555,000,000

Potential number of beginning farmer opportunities with these funds (based on FY 1989 and 1990 average size loans):

Direct OL borrowers: 10,000 (10,000 times $40,000 equals $400,000,000)
Guar OL borrowers: 5,556 (5,556 times $90,000 equals $500,000,000)
Direct FO borrowers: 5,449****
Guar. FO borrowers: 2,449*****
Total borrowers: 23,454

*FY 1991-93 proposed direct OL appropriations each include $100,000,000 for natural disaster loans made through and under the provisions of the OL program. Alternatively, separate EM appropriations of $100,000,000 would easily meet the EM demand present in recent years.

**Direct only.

***Not less than 25% of this appropriation would be used for conventional limited resource FOs in accordance with current legislation.

****This number represents the increased borrowers made possible becuase of the new 10% down payment requirements and an addition 25% made possible because of the leveraging of non-FmHA funds made possible with down payment loans. ($325,000,000 divided by $82,000=3963 times 1.10% equals 4,359 times 1.25% equals 5,449 borrowers).

*****This number represents the increased borrowers made possible becuase of the new 10% down payment requirements. ($325,000,000 divided by $146,000 equals 2,226 times 1.10% equals 2,449).

Estimated cost of providing borrower training and loan assessment when 23,454 new beginning farmer loans were made:

Loan assessment costs: $8,000,000 (23,454 borrower plus 16,546 unsuccessful applicants equal 40,000 applicants times $200)

Borrower training costs: $7,036,200 (23,454 borrowers times $300)

Limited resource borrower training costs: $4,000,000 (8,000 times $500)

Total costs: $19,036,200

While it is impossible to estimate the exact cost of interest assistance that would be provided on beginning farmer direct and guaranteed loans, a ballpark figure of $64,000,000 should be close to the potential cost. This amount would provide 4% interest assistance on the entire proposed $1.6 billion in proposed beginning farmer appropriations.

X. Miscellaneous Reforms.

A. Soil and Water Conservation Loans. The current Soil and Water

Conservation Loans have often been used for irrigation and land development which had negative environmental consequences. The authorization for these loans should be revised to emphasize conservation and sustainable agriculture. Priority for the loans would be given to borrowers adopting low-input sustainable agriculture practices and to producers who use the loan funds to build conservation structures to achieve conservation compliance. The loans would be limited to $50,000, and the appropriation authorization would be increased from $14 million ($11 million direct and $3 million guaranteed) to $50 million ($40 million direct and $10 million guaranteed). (This proposal and the following section on OLs are contained in Senator Fowler's "Farm Conservation and Water Protection Act of 1989" S. 970.)

B. Operating Loans. This "Fowler Bill" proposal would expand the eligible purposes for OLs to include financing for construction incident to converting to low-input sustainable farming practices and to achieving compliance with conservation requirements.

C. Need to Rely on Farm Income. Until October 14, 1988, when new FmHA regulations went into effect, an FmHA borrower had to "need to rely on farm income" in order to be eligible for FO and OL loans. The new regulations removed this requirement. The current statutory requirements are citizenship, sufficient training or farming experience, family farm size, and no credit available elsewhere. The statute does require a limited resource borrower to "demonstrate a need to maximize" farm income and in breaking a tie between eligible bidders on inventory property the County Committees are to look at the person who "has the greatest need for farm income." The "no credit elsewhere" eligibility test partially, but not adequately, addresses the need to provide off-farm income guidelines.

While it is apparent that some off-farm income is often necessary and desirable, some standard is needed to prevent persons with high off-farm incomes from being eligible to receive limited FmHA loan funds. This proposal would limit permissible off-farm income to states' median household income. Setting a precise off-farm income limit would prevent arbitrary application of the criteria and would help ensure that the limited funds are going to people most in need of FmHA assistance. Without legislative guidance the amount of allowable off-farm income has varied widely across the country. The 1980's farm crisis pointed out the need for off-farm income and perhaps resulted in the regulations change mentioned above, but FmHA can not and should not provide subsidized credit to applicants who already have adequate standards of living and could in most cases enter farming on their own.

D. County Committee Training. FmHA County Committees have been given increased responsibilities in the last few years but training for the members has been haphazard. This proposal would require that FmHA provide annual training to the committee members on all of their job responsibilities. Annual training is critical because there is potentially at least one new member on each committee each year.

E. Family Farm Definition. The intent of this proposal is to better assure proper targeting of loans to family-size farms. The definition uses family management and labor inputs as the yardsticks of a "family farm." Given the diversity of farming units in this country, this approach is preferable to a definition based on other indexes such as acreage or sales. The proposal would require that a majority of the labor be provided by the borrower and any immediate family members.

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Information Alert 90-02
February 14, 1990

Contact: Jerry Hansen
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The Administration's FmHA Proposals: New Initiatives But No New Opportunities

Summary: The Administration's 1991 farm bill proposal provides a blueprint for FmHA that has two potentially useful initiatives for farm program lending--one involving interest assistance on FmHA guaranteed loans and another that would limit borrower eligibility for assistance. These initiatives appear to be a start in the right direction. Unfortunately, the proposed mix of appropriations would, at best, allow FmHA to marginally maintain its current borrowers, but the agency would not be able to provide any significant number of farm entry opportunities. That should be FmHA's most important job. FmHA can and should provide those opportunities within likely budget constraints and in a manner that protects the government's interests.

The budget proposed for FmHA is partially beneficial in theory but in practice continuingly unresponsive to a pressing need for federal lending which focuses on the needs of beginning farmers and facilitates the transfer of farming assets from retiring to new entry farmers. About half of all farming assets are owned by farmers who are expected to retire in the next ten years. The transfer of these assets is an historic opportunity, and it will be the single most important factor affecting the social and economic health of agriculturally based rural communities. Without effective FmHA lending programs those assets will go primarily to larger farmers and nonfarm investors. With target, fiscally sound beginning farmer lending programs, FmHA can play a major role in promoting healthy, economically viable rural communities. For decades FmHA provided entry opportunities for farmers who built viable operations and were able to repay FmHA credit. There is no reason the agency cannot provide that assistance again.

Both Clayton Yeutter and Cooper Evans have stated their support for federal government credit assistance to beginning farmers, but somewhere in the budget process that support disappeared. The Administration's budget proposal is not directed to the needs of beginning farmers. It instead is a blueprint for maintaining an agency which rather grudgingly assists those already in debt to FmHA and provides some assistance, primarily through guarantees, to the established farm borrowers of commercial and cooperative lenders.

"Subsidized Guarantees": A History of Failure

As stated above, some parts of the budget proposal are potentially beneficial. The first calls for "subsidized guarantees" on $350,000,000 in guaranteed operating loans (OL) and $50,000,000 in guaranteed farm ownership loans (FO). This approach can ease the transition from direct to guaranteed credit for FmHA borrowers, and it could get some FmHA eligibile borrowers directly into the commercial credit system. It's not a new idea, and unfortunately, it has a history of failure. It was tried without much success in the 1985 Farm Bill (the "interest buydown" program) and again in the 1987 Ag Credit Act (the FCS Demonstration Project).

This history of interest-assisted guaranteed loans indicates that this approach needs careful implementation if it is intended to be anything other than a token program, let alone a program capable of reaching beginning farmers. Nothing in the FmHA proposals show the innovation or attention to detail needed to launch a new program that would make guaranteed loans available to traditional FmHA borrowers including beginning farmers. In fact the Administration proposal states that the proposed modification to the guaranteed OL program is designed to "1) to facilitate the transition of existing direct loans borrowers to guaranteed loans and ultimately to private sector credit; and 2) to provide a source of assistance to current borrowers of private lending institutions who can no longer continue with those lenders on commercial terms." These are useful purposes for guaranteed OLs but they exclude small farmers who wish to expand to family size but don't have direct loans and beginning farmers. Guaranteed OLs must be available to small and beginning farmers if these loans are in part to replace direct OLs.

Planned "Graduation"

The second potentially beneficial proposal involves limiting eligibility for FmHA direct loan assistance to seven years for individual borrowers. FmHA should provide effective temporary assistance to direct borrowers so that they are able to graduate to guaranteed or commercial credit in short order. However, "coldturkey" graduation won't work. It must be planned graduation: borrowers must be prepared if they are to successfully make these steps up the credit ladder. Simply saying "seven years and out" in no way assures the financial and management growth needed for borrowers to make these steps. FmHA can and should help borrowers' growth if for no other reason than to better assure graduation and repayment of FmHA debts. Flexibility is needed if the agency and its borrowers are to be able to respond to real world conditions.

Graduation can be enhanced if borrowers are prepared, while receiving FmHA assistance, to deal with commercial lending. To do this the administration proposed the use of "underwritng forms, standards, practices and terminology consistant with the private sector to the maximum extend possible". If properly implemented, this can be a useful initiative, but FmHA's attempted adoption of the Coordinated Financial Statements in the early 1980s (later prohibited by Congress) shows that new forms and terminoloogy must be accessible to both FmHA employees and borrowers for them to be of value. Accessibility through training and proper form selections is necessary if this initiative is to be successful.

Beginning Farmers Left Out

Going beyond the promising initiatives, the proposed budget appropriation levels show little support for or understanding of FmHA's mission or the pressing need for beginning farmer lending. The budget also shows a preoccupation with guaranteed loans with little regard to their limited use in recent years.

Specifically, the proposed appropriation levels would provide:

(1) Combined direct and new subsidized guarantee OL funds roughly equivalent to FY 1988 and 1989 actual use of direct OL funds. Even assuring complete use of subsidized guarantees, this means very few new farming opportunities provided through the OL program because current direct borrowers will absorb most of those funds to continue their operations.

(2) Direct FO funds of $38,000,000 with all funds reserved for socially disadvantaged (SDA) borrowers. It's good to see a recognition that FmHA lending has often systematically excluded minority farmers. But just as direct FOs are valuable credit assistance for SDA borrowers, they are also an irreplaceable entry tool for all farmers. Limiting direct FO eligibility to SDA borrowers would be extremely divisive in many parts of the country and would ignore the value of these loans to a wide variety of beginning farmers.

(3) New subsidized guaranteed loans for guaranteed loans (FO & OL) estimated to average 3% on a maximum of $400,000,000 in loans per year. At these levels the total interest assistance would be $12,000,000 nationally. This amount would provide little help for borrowers trying to graduate to guaranteed credit or for new applicants who would with adequate assistance be able to get started with guaranteed loans. At the 3% level, these funds would, for instance, permit less than two subsidized guarantees in each Nebraska county per year.

(4) Guaranteed OL appropriations of $2,250,000,000. This level would provide a supply of funds far in excess of the demand which can be reasonably anticipated. FY 1988 and 1989 guaranteed OL lending averaged about $900,000,000 in spite of extensive agency efforts to make more of these loans. The guaranteed interest assistance may add to the demand for these loans, but full use of the $350,000,000 proposed and continued lending of $900,000,000 in unsubsidized guaranteed, would still leave one billion dollar in unused funds. Appropriating funds that will not be used may be politically attractive, but it adds to neither agency effectiveness nor to the number of farming opportunities FmHA provides.

All of the above indicate a kind of business as usual at FmHA that is not desirable for several reasons. First, FmHA has had a notable lack of success in recent years in graduating its borrowers to commercial credit. The proposed budget would add little to make graduation more likely from either a financial or managerial standpoint. Second, FmHA lending has resulted in far too many borrower failures and far too much government loss in recent years. The budget would diminish these failures and losses only to the extent it limits overall lending. The alternative--using FmHA supervised credit to help build viable farming operations which are able to repay their FmHA debt--is nearly ignored. And, third, the budget would provide almost no opportunities for new farmers to use FmHA credit to start and build their operations.

The Center has developed a number of reform proposals which address these concerns. The proposals are available on request.

Senator CONRAD. Thank you very much. Mr. Emm, please hot foot it to the plane.

Mr. EMM. Thank you very much. Appreciate it.

Senator CONRAD. And if you do not make it, Sox Johnson is in the phone book, and I think we will just——

[Laughter.]

Mr. Paige, you are a patient man. We very much appreciate your being with us. Let me indicate that Senator Fowler had asked that we contact him when you were about to testify because he wanted to be able to introduce you. Because we have now gone substantially beyond the time we intended because of votes on the floor, Senator Fowler is not available, but he did want to let you know that he intended to be here to introduce you to the committee. My apologies.

STATEMENT OF RALPH PAIGE, ON BEHALF OF INTERFAITH ACTION FOR ECONOMIC JUSTICE AND THE FEDERATION OF SOUTHERN COOPERATIVES/LAND ASSISTANCE FUND, ATLANTA, GA

INTRODUCTION

Mr. PAIGE. My name is Ralph Paige. I appreciate the opportunity to make this statement on behalf of the 15,000 low income, black family farmers in the membership of Federation of Southern Cooperatives/Land Assistance Fund. With the Interfaith Action for Economic Justice, we share a deep concern about the status of minority family farmers on the land, and a commitment to maintain and rebuild the minority land base of this nation.

CREDIT IS ESSENTIAL TO THE SUCCESS OF MINORITY FARMERS

Credit is essential if we are to be successful in keeping the land base that we now have or increase it. As we review the results of the 1985 farm bill and suggest new programs, our overriding concern is to keep minority farmers on the land and enable them to share the benefits of the farm credit and other programs written in the new farm bill. Very few congressional initiatives have specifically addressed the concerns first presented comprehensively in a 1982 report of the United States Civil Rights Commission.

BACKGROUND ON THE PROBLEMS OF BLACK FARMERS

The Civil Rights Commission report, entitled "The Decline of Black Farming in America," assessed the status of black farmers in the United States. The Commission found that, according to the 1978 Census of Agriculture, only 57,271 farms were owned by blacks, down 57.3 percent from a decade before.

The report continued, "At this rate of loss," the report predicted "there will be virtually no black farmers in this country by the end of the next decade." With the exception of one small initiative in the 1985 farm bill and others in the 1987 Agricultural Credit Act, Congress and the administration have failed to comprehensively address the problems set forth 8 years ago in the Civil Rights report or use government institutions to act as positive force to affirmatively redress previous and continuing inequities. Meanwhile, black farm loss has continued unabated.

Today there are less than 37,000 black farmers left in America.

THE FMHA MISSION AS LENDER OF LAST RESORT

Over the last number of years, congressional and administrative policies have increasingly altered the mission of the Farmers Home Administration away from its traditional and mandated role as the lender of last resort to limited resource farmers. As the number of financially distressed operators of larger economic size began to receive disaster and other emergency loans during the continuing farm crisis in the 1980's, minority farmers had increased competition for the scarce loan funds. Loans to minority farmers decreased in amount, and more farmers were turned away. In particular, owners and operators of relatively small farm who had successfully remained on the land for many years were more and more often told that their operations were too small to be viable. These loans were, and still are, rejected, leaving a whole class of minority borrowers without access to credit.

THE SHIFT OF FUNDS FROM DIRECT TO GUARANTEED LENDING

The shift of funds from direct to guaranteed lending is a major concern of our organization and of black farmers, if we are to survive. Credit resources have always been inadequate to meet the needs of minority farmers. In the 1985 farm bill, Congress approved shifting funds from FmHA direct lending programs to a program which guarantees the loans made to farmers by commercial lenders. The President's budget, just released, recommended further shifts in this direction.

In our experience, commercial lenders do not loan to black farmers, and they have received only a negligible number of guaranteed loans. The transfer of resources from direct loans to the guaranteed loan program is, in effect, a program which targets more Federal resources away from black farmers and other minority farmers.

I think one of the people from GAO commented on this, and we look at is as just another way of bailing out some banks. A lot of banks are using these funds presently to take loans that are bad to get guarantees on them. So I think there needs to be some way to investigate how guarantee loans are being misused. Our data and experience indicates that if minority farmers are underrepresented in the direct loan program compared to their representation in population, the situation is far worse for guaranteed loans. A shift in Federal policy toward guaranteed loans is, in effect, a direct shift away from minority farmers and their ability to remain in business.

On last Saturday, February 3, 1990, we held a meeting in Albany with over 200 black farmers in rural Georgia. In fact, at this meeting we had the honor of having Congressman Hatcher to attend and be our speaker. Some farmers made reference to some of the things that have been discussed today, mainly credit and guarantee loans. I want to read just a comment or two that farmers gave.

COMPLAINTS

One, direct loan funds are very tight. In some States, Georgia and Florida, FmHA is giving recognition to County Supervisors based on how many borrowers they push to graduate into the guaranteed program. Producers were receiving intense pressure to move into a program where they cannot succeed. The FmHA can deny direct loans on this basis but it cannot assure commercial lenders will make guaranteed loans in adequate amounts. Also, most commercial loans have interest rates as high as 14 percent, which many black farmers cannot afford. In fact, no farmers can afford that kind of interest rate.

Another complaint is loans to black farmers are not being approved in a timely fashion. The timing of processing and approval falls too late for planting. Loan levels are consistently below the amount requested and needed. The farmers are not receiving adequate technical support from FmHA staff. We realize there is a problem there. There is not enough staffing. FmHA has moved from the traditional mission of helping farmers like they were set up so there is a real problem.

APPEALS

The appeal process was also brought up and was another grave concern of black farmers or the farmers at the conference.

Black farmers have begun to move more readily to appeal decisions made against them. Recently, however, the Farmers Home Administration has set a new policy which will allow FmHA to seek to have successful appeals overturned. We believe this practice serves primarily to discourage borrowers from making appeals and from continuing in farming. Through this process we have heard lots of complaints where farmers win on appeal and FmHA officials tell them their intent to appeal that particular decision. If FmHA wins the right to reappeal it is going to cause a lot of farmers to go out of business.

CURRENT PROGRAMS TO ASSIST BLACK FARMERS

In response to the 1982 Civil Rights Commission report, staff members of the Farmers Home Administration did administratively establish a small farm technical assistance program. The program, operated by the FmHA Office of Personnel Training Division, has received funds of approximately $1 million per year since 1983, from that division's budget. In the 1985 farm bill, the Department was instructed to continue operating the program "at substantially the current amounts." The Office of Advocacy and Enterprise, set up to handle equal opportunity employment with USDA national offices, cooperates closely in the development of cooperative agreements with the 1890's institutions and community based organizations, but the Personnel Training Division actually makes the grants.

In this history of this particular program, only $100,000 has been allotted to community based organizations working directly with minority farmers on a day-to-day basis.

Our organization was awarded that particular grant and I will not go into the details but we have far exceeded the expectation of the program. We have helped up to 600 farmers out of that particular pool money, we have restructured millions of dollars of debt and helped a lot of farmers to stay in business. This has been a very valuable program.

The Small Farm Technical Assistance Program does not have a line item budget or permanent authorization. The funds are mostly spread among black land-grant colleges and are already inadequate for those programs. Almost no money is left to assist community based organizations who have worked directly with minority farmers to help them stay on the land. Providing such resources is essential for the success of efforts to include minority farmers to participate equitably in FmHA programs, and to accomplish a more comprehensive reforms contained in the credit title of the Minority Farmers Rights Act. Regular authority and an expanded funding base of at least $5 million will be necessary before this program can serve black farmers in even a minimally adequate fashion.

THE SOCIALLY DISADVANTAGED PROGRAM

In the Agricultural Credit Act of 1987 and with the essential support of this subcommittee, we were able to target the resources of two Federal FmHA programs to minority producers based on their population in a particular county. These provisions are already providing minority producers with resources that have not been available in the past. The language required the FmHA to assure minority farmers access to a fair share of Farm Ownership loans and land inventory sales programs. The $11 million allocated nationally in fiscal year 1989 to these programs were fully spent, and an additional $1 million was reprogrammed from other sources to meet these demands of minority farmers.

NEEDED CHANGES IN THE FEDERAL FARM AND CREDIT POLICIES

The Federation of Southern Cooperatives/Land Assistance Fund and other minority farm organizations, in cooperation with Interfaith Action and other progressive farm groups, has designed a more comprehensive approach to stem the tide of minority land loss, to help existing minority farmers to fully use and develop their land resources, and to support programs for new and reentering minority farmers.

PROVISIONS OF THE PROPOSED MINORITY FARMERS RIGHTS ACT

A comprehensive approach to minority farm loss, including provision for adequate credit, is long overdue. The proposed Minority Farmers Rights Act includes specific provisions to address the concerns listed above. The goals of this legislation are to:

First, immediately arrest the loss of minority land and minority operated farms.

Second, by the year 2000, restore the level of black land ownership to 15 million acres.

Third, increase minority land ownership and farm operation to a level commensurate with the rural minority population in each region of the Nation.

Fourth, eradicate racial discrimination and indifferences to the special needs and problems of minority farmers, from all programs administered by the Secretary.

SPECIFICALLY

The proposed Minority Farmers Rights Act would extend socially disadvantaged credit programs to all relevant areas of USDA credit and other farm programs. In addition, the bill will recommend that a certain percentage of the total nation pool of direct loans be allocated in a "special impact program" to ensure that limited resource white farmers in poor areas with high minority populations do not bear the full burden of correcting existing inequities in the direct lending program.

We fully recognize that the Farmers Home Administration offices in some areas are understaffed to supply the services that we advocate and to undertake the increased responsibilities of expanded socially disadvantaged programs. As a result, the bill would include increased FmHA staff specifically assigned to these activities in the areas with high minority populations.

THE BILL WILL HELP

The bill will strengthen staff agencies within USDA and the State and local level to deal with the concern of minority farmers.

It would require the development of a national register of minority farmers and land base within county ASCS offices, and be used to maintain and increase minority ownership of land. Regular reports to Congress on movement toward the goals set forth in the bill are also stipulated.

Develop an expanded outreach program involving the 1890 Land-Grant Colleges and community based organizations like the Federation of Southern Cooperatives, Rural Advancement Fund, Arkansas Land and Farm Development Corporation, engaging them in specific contracts to involve minority farmers in all aspects of USDA programs.

Require affirmative action in employment and contracting by USDA agencies, including the Farmers Home Administration.

Establish demonstration programs for minority youth and beginning farmers.

Establishing a stronger appeals process for complaints of discrimination by minority farmers.

CONCLUSION

Mr. Chairman, I appreciate the opportunity to make this presentation and hopefully that this committee will consider it, especially the minority farmers bill, and I would ask members of the committee to support it and see that all these particular portions of this bill be included in the 1990 farm bill.

[The prepared statement of Mr. Paige follows:]

The Federation of Southern Cooperatives/
Land Assistance Fund

Public Relations and Fund Raising Office
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TESTIMONY

to the
SENATE AGRICULTURE COMMITTEE
SUBCOMMITTEE ON AGRICULTURE CREDIT

by
RALPH PAIGE

on behalf of
INTERFAITH ACTION FOR ECONOMIC JUSTICE
and
FEDERATION OF SOUTHERN COOPERATIVES/LAND ASSISTANCE FUND

February 8, 1990

Interfaith Action for Economic Justice
110 Maryland Ave. NE, Washington, DC 20002 202/543-2800

My name is Ralph Paige. I appreciate the opportunity to make this statement on behalf of the 15,000 low income, Black family farmers in the membership of the Federation of Southern Cooperatives/Land Assistance Fund. I also speak today on behalf of Interfaith Action for Economic Justice, an advocacy organization of 34 national Protestant, Roman Catholic, and Jewish agencies that work together to develop and implement more just U.S. domestic and international policies. As people of faith, we share a deep concern about the status of minority families on the land, and a commitment to maintaining and rebuilding the minority land base in this nation.

Credit Is Essential to the Success of Minority Farmers

As we review the results of the 1985 Farm Bill and suggest new programs, our overriding concern is to keep minority farmers on the land and enable them to share the benefits of farm credit and other programs written in the new farm bill. In 1990, **Black farmers continue to lose their land at a rate 2 1/2 times faster than White farmers. Historical patterns of discrimination, lack of access to resources and training have not been erased.** Moreover, very few Congressional initiatives have specifically addressed the concerns first presented comprehensively in a 1982 report of the United States Civil Rights Commission.

Background on the Problems of Black Farmers

That Civil Rights Commission report, entitled "The Decline of Black Farming in America," assessed the status of Black farmers in the United States. The Commission found that, according to the 1978 census of Agriculture, only 57,271 farms were owned by Blacks, down 57.3 percent from the decade before. During this period, Black farmers lost land at a rate 2 1/2 times that of White farmers. At the peak in 1920, there were 926,000 Black-operated farms. One-seventh of all farms, or about 15 percent, were owned by Blacks. Since 1920, also the peak year for the number of all farms, almost 94 percent of all Black owned farms were lost, compared to a 56 percent loss of White owned farms.

"At this rate of loss," the report predicted, "there will be virtually no Black farmers in this country by the end of the next decade." With the exception of one small initiative in the 1985 Farm Bill and another in the 1987 Agriculture Credit Act, Congress and the Administration have failed to comprehensively address the problems set forth eight years ago in the Civil Rights report, or use government institutions to act as a positive force to affirmatively redress previous and continuing inequities. Meanwhile, Black farm loss has continued unabated.

According to USDA estimates, and using the USDA definition of "farmer," the number of Black farmers fell to 37,000 by 1987. The Federation estimates that figure would be closer to 35,000 or less today. However, if all Black farmers were counted, and the definition of "farmer" was expanded to include the very small full-time farmers whose gross production falls below USDA definitions, there may still be 50,000 Black farm families whose operations can still achieve prosperity. With proper resources, many former farmers could return to the land, and more youth could begin farming.

Many barriers must be removed if minority land ownership is to be maintained and restored. Our contacts with farmers in a 10 state region reaffirm for us daily that historical patterns of discrimination, lack of access to credit and other resources, limited education and training still exist for the vast majority of minority farmers.

Furthermore, the Farmers Home Administration, the federal government's lender of last resort to small family farmers, has contributed to the loss of minority owned and operated farms through specific acts of discrimination, and general policies of indifference to the unique problems of minority producers.

Recent Congressional action, including the shift begun in 1985 of funds from direct to guaranteed loan programs in the Farmers Home Administration, and the expansion of the emergency loan program to include relatively larger farmers who had not previously received FmHA loans, have further strained the already limited access of minority farmers to federal resources, including credit. I will now review some of these problems.

The FmHA Mission as Lender of Last Resort

Over the last number of years, Congressional and Administrative policies have increasingly altered the mission of the Farmers Home Administration away from its traditional and mandated role as the lender of last resort to limited resource farmers. **As the numbers of financially stressed operators of larger economic size began to receive disaster and other emergency loans during the continuing farm crisis of the 1980s, minority farmers had increased competition for scarce loan funds.** Loans to minority farmers decreased in amount, and more farmers were turned away. In particular, owners and operators of relatively small farms who had successfully remained on the land for many years were more and more often told that their operations were too small to be viable. These loans were, and still are, rejected, leaving a whole class of minority borrowers without any access to credit. As the size of the loans in FmHA's overall portfolio increases, the relatively smaller minority farmers have declining access to resources.

At the same time, FmHA personnel have spent more time working with larger farmers. Their increased duties have left them less time or ability to meet in a training or supervisory role with smaller farmers who need additional assistance. In recent years, FmHA field staff have been unable to simply process loans in a timely fashion. We see a persistent problem throughout the south in getting loans approved in time for planting.

The Shift of Funds from Direct to Guaranteed Lending

Credit resources have always been inadequate to meet the needs of minority farmers. In the 1985 Farm Bill, Congress approved shifting funds from the FmHA direct lending programs to a program which guarantees the loans made to farmers by commercial lenders. The President's budget, just released, recommends further shifts in this direction.

In our experience, commercial lenders do not loan to Black farmers, and they have received only a negligible number of guaranteed loans. The transfer of resources from direct lending to the guaranteed program is, in effect, a program which targets more federal resources away from Black and other minority farmers. House Members have already requested specific data from the FmHA on the number and percentage of guaranteed loans which are made to members of minority groups by state and county, compared to the proportion of direct loans made to minorities. Our data and experience indicates that if minority farmers are underrepresented in the direct loan program compared to their representation in the population, the situation is far worse for guaranteed loans. A shift in federal policy towards guaranteed loans is in effect a direct shift away from minority farmers and their ability to remain in business.

On Saturday, February 3 of 1990, the Federation of Southern Cooperatives staff met with 200 Black farmers in rural Georgia, one in a continuing series of meetings. In our conversations with the farmers, we identified the following specific complaints, which we have heard repeatedly throughout our 10 state region:

1. Direct loan funds are very tight. In all parts of Georgia and Florida, FmHA is giving recognition to County Supervisors based on how many borrowers they push to graduate into the guaranteed program. Producers were receiving intense pressure to move into a program where they cannot succeed. The FmHA can deny direct loans on this basis but it cannot assure commercial lenders will make guaranteed loans in adequate amounts. Also, most commercial loans have interest rates as high as 14 percent, which many Black farmers cannot afford.

2. Many Black farmers are denied access to adequate direct loans, in larger numbers than White farmers. Producers complain of continuing discrimination both subtle and overt forms, and are often discouraged from even submitting applications. They are told they are ineligible because family members hold off-farm jobs or their operation is too small to be considered a farm. Applications are also rejected for vegetable growers, who are told loans are only being made for peanut or other commodity producers. Black producers often lack access to peanut or program crop base, so this rejection exacerbates previous patterns of discrimination.

3. Loans to Black farmers are not being approved in a timely fashion. The timing of processing and approval falls too late for planting. Loan levels are consistently below the amount requested. And farmers are not receiving adequate technical support from FmHA staff.

4. Guaranteed lenders reject Black farmers, often on the basis of the small size of their farms, the type of operation, their perceptions of the skills of Black farmers and their general unwillingness to increase portfolios in the agriculture sector. In comparable economic classes and farm size, Black farmers perceive they will receive markedly less favorably consideration than White farmers from commercial lenders.

As a result of actions like those listed above, the number and amount of loans still fall below the target participation rates for minority farmers established for the farm ownership loan program in the 1987 Agriculture Credit Act. Further data collection and analysis is essential to identifying and removing barriers to minority participation in FmHA direct lending programs.

Appeals

Black farmers have begun to more readily appeal decisions made against them. Federation staff have assisted more than 50 farm families in successful appeals which overturn decisions made against them. Recently, however, the Farmers Home Administration has set new policy which allows the FmHA to seek to have successful appeals overturned. We believe this practice serves primarily to discourage borrowers making appeals from continuing in farming. Farmers are routinely denied access to operating loans during the appeals process. Adding yet another step to that process serves primarily to allow the lender much more ability to starve the family off the farm during the appeal.

Discrimination complaints have also been filed in a number of areas. The processing of discrimination complaints remains very slow. The risk to the producer filing the complaint is high, as most Black farmers cannot survive without operating loans or other resources during the time the complaints take to process.

Summary of Problems

Black farmers have traditionally lacked access to the credit necessary to expand and prosper in their farming operation. Recent Congressional decisions which have increased the size of operations of FmHA borrowers and shifted funds from direct to guaranteed loan programs have moved the FmHA farther away from its traditional mandate as the lender of last resort. Such policies only intensify the problems of minority producers who by law should be primary clients of FmHA, by virtue both of the relatively smaller size of their operation and because alternative credit sources have been denied them for reasons of both discrimination and economics. We feel this situation can be ameliorated. I would like to spend the final minutes of my testimony outlining some positive accomplishments and possible policy directions.

Current Programs to Assist Black Farmers

The Small Farm Technical Assistance Program

In response to the 1982 Civil Rights Commission report, staff members of the Farmers Home Administration did administratively establish a "Small Farm Technical Assistance Program." The program, operated by the FmHA Office of Personnel Training Division, has received funds of approximately $1 million per year since 1983, from that division's budget. In the 1985 Farm Bill, the Department was instructed to continue operating the program "at substantially current amounts." The Office of Advocacy and Enterprise, set up to handle equal opportunity employment within the USDA national offices, cooperates closely in the development of cooperative agreements with 1890s institutions and community based groups, but the Personnel Training Division actually makes the grants.

Although the Small Farm Technical Assistance Program is designed to assist both 1890s land grant institutions and community-based organizations working with minority farmers to carry out its stated purposes, available funding has never covered all the needs of the 1890s institutions. **In the history of the program, only $100,000 has been allocated to community-based organizations working directly with minority farmers on a day-to-day basis.**

The Federation was the recipient of this single, one time grant which has not yet been renewed due to inadequate funding. The contract required the Federation's Albany, Georgia office to assist 30 limited resource, at-risk borrowers prepare farm diversification plans through special counseling and technical assistance. The three staff members working on the contract stretched those resources. More than 100 limited resource farmers were assisted with farm diversification plans. In addition, the same staff helped 250 farmers submit restructuring plans to FmHA; assisted applicants in the State of Georgia prepare requests and receive FmHA Farm Ownership loans under the socially disadvantage program approved in the 1987 Agriculture Credit Act; helped 25 vegetable growers organize the Flint River Farmers cooperative to assemble and market their produce; held an annual "Small Farmers Conference," which attracted a bi-racial group of more than 250 farmers; and assisted Georgia farmers to participate in the Federation's "Farm to Market Program" which sold vegetables and fruit directly to consumers through sales in church and synagogue parking lots in urban centers. During the same period, that office's hotline helped more than 600 Georgia farmers of all races restructure loans under the provisions of the 1987 Agriculture Credit Act. The Georgia state FmHA offices praised them for their efforts.

Such direct assistance in securing federal resources and training is essential to minority farmers. Community based organization like the Federation have the expertise to work within the minority community, and can undertake outreach and training programs more efficiently and with fewer resources than government offices.

This Small Farm Technical Assistance program does not have a line item budget or permanent authorization. The funds are mostly split among the Black land grant colleges and are already inadequate for those programs. Almost no money is left to assist the community based organizations who have worked directly with minority farmers to help them stay on the land. Providing such resources is essential for the success of efforts to include minority farmers to participate equitably in FmHA programs, and to accomplish more comprehensive reforms contained in the credit title of the Minority Farmers Rights Act. Regular authority and an expanded funding base of at least $5 million will be necessary before this program can serve Black farmers in even a minimally adequate fashion.

The Socially Disadvantaged Program

In the 1987 Agriculture Credit, and with the essential support of this subcommittee, we were able to target the resources of two federal FmHA programs to minority producers based on their population in a particular county. These provisions are already providing minority producers with resources that have not been available in the past. The language requires the

FmHA to assure minority farmers access to a fair share of the farm ownership loan and land inventory sales programs. The $11 million allocated nationally in FY 1989 to these programs was fully spent, and an additional $1 million was reprogramed from other sources to meet the demands of minority farmers

The Federation has assisted more than 20 farmers to successfully acquire land under this program, with more applications under preparation. When farmers are assured a fair chance of receiving funds, they are more willing to begin the process. However, expanding this socially disadvantaged program, which is modeled after programs in the Small Business Administration, to the operating loan program is essential. Although FmHA has implied that they will assist these purchasers in receiving operating loans, many of these socially disadvantaged borrowers have been unable to get the operating loans which are essential to their success.

We have encountered other problems in the operation of this program. One farmer who currently owns 50 acres, and rents 200 acres tried to use the socially disadvantaged program to purchase 200 acres more from inventory. Despite his willingness to make an adequate down payment, the FmHA office was requiring him to extend the mortgage to his 50 acre parcel of land which had been in the family for many years. FmHA office seems to be operating the program with an instruction that, if the loan is economically feasible, everything the farmer has as collateral in addition to down-payment should be attached. By operating the program so, FmHA is facilitating land loss in a program designed to increase land holdings.

Needed Changes in Federal Farm and Credit Policy

The Federation/LAF and other minority farm organizations, in cooperation with Interfaith Action and progressive farm groups, has designed a more comprehensive approach to stem the tide of minority land loss, to help existing minority farmers to fully use and develop their land resources, and to support programs for new and re-entering minority farmers.

Key features of the legislation are based on language in Section 8(a) of the Small Business Act which sets aside government contracts for minorities. Under this program, "minority" is defined as a member of a group that has been subjected to racial or ethnic prejudice or cultural bias because of their identity as a member of a group, including Blacks, Hispanics or others, without regard to the individual qualities of that person. The socially disadvantaged programs in sections 617 and 623 of the Agriculture Credit Act of 1987 are modeled on that concept.

Provisions of the Minority Farmers Rights Act

A comprehensive approach to minority farm loss, including provision for adequate credit, is long overdue. The proposed Minority Farmers Rights Act includes specific provisions to address the concerns listed above. The goals of this legislation are to:

1) Immediately arrest loss of minority land and minority operated farms.
2) By the year 2000, restore the level of Black land ownership to 15 million acres.

3) Increase minority land ownership and farm operation to a level commensurate with the rural minority population in each region of the nations and,
4) Eradicate racial discrimination and indifference to the special needs and problems of minority farmers, from all programs administered by the Secretary.

Specifically:

- The proposed Minority Farmers Rights Act would extend these socially disadvantaged credit programs to all relevant areas of USDA credit and other farm programs. In addition, the bill recommends that a certain percentage of the total nation pool of direct loan funds be allocated in a "special impact program" to ensure that limited resource White farmers in poor areas with high minority populations do not bear the full burden of correcting existing inequities in the direct lending program. The current draft of the bill also encourages a restoration of the mission of the Farmers Home Administration as the lender of last resort, restoration of direct lending funds to 1985 levels, and advocates positive affirmative action in lending among the credit institution participating in any guaranteed loan program.

- We fully recognize that the Farmers Home Administration offices in some areas are understaffed to supply the service we advocate and to undertake the increased responsibilities of an expanded socially disadvantaged program. As a result, the bill would include increased FmHA staff specifically assigned to these activities in areas with high minority populations.

The bill would further:

- Strengthen and staff an agency within the USDA and at the state level to deal with the concerns of minority farmers.

- Require the development of a national registry of minority farmers and land base within county ASCS offices, and be used to maintain and increase minority ownership of land. Regular reports to Congress on movement toward the goals set in the bill are also stipulated.

- Develop an expanded outreach and education program involving the 1890 Land Grant Colleges and community based organizations like the Federation and our sister agencies including the Rural Advancement Fund in the Carolinas and the Arkansas Land and Farm Development Corporation, engaging them in specific contracts to involve minority farmers in all aspects of USDA programs.

- Require affirmative action in employment and contracting by USDA agencies, including the Farmers Home Administration.

- Establish demonstration programs for minority youth and beginning farmers

- Establish a stronger appeals process for complaints of discrimination by minority farmers.

Passage of the provisions of this act will provide minority producers with resources that have not been available in the past, and I urge your support for the provisions relevant to the credit title of the 1990 Farm Bill. Thank you for your attention to this important issue.

Senator CONRAD. Very good. Very excellent. Your testimony is of great assistance to the committee. I can say to you you have brought before us a comprehensive proposal, and it will certainly be given close consideration as we move ahead on writing the credit title. Let me, if I can, ask those of you who have so patiently stayed with us for this hearing, we have heard a number of recommendations from the Administration. You have responded to them in your testimony.

If I could summarize what I am hearing, maybe you could tell me if I am hearing correctly. The greatest concern that I have heard is the continuing movement to guaranteed loans from direct loans. Would that be something that would be high on your list of priorities to turn around in terms of the proposal of the administration?

Mr. PAIGE. Let me respond. According to the farmers at the meeting that we had in Albany, it just does not work for black farmers. Already most people know that we have had problems with the banking system making lending, red-lining and lending to minorities. This just would devastate black farmers if FmHA were to only provide guaranteed loans. Already we had numerous reports at our meeting that it is just not working.

Senator CONRAD. Not working. Others?

Ms. BALDWIN. Mr. Chairman, it is not working for any farmers. Banks in our areas will not do an initiated guarantee loan. They will only do guarantee loans for farmers who they know are in trouble who they do not want to lose the money from the farm.

Senator CONRAD. Those farmers who are the banks' existing clients?

Ms. BALDWIN. Right. Only existing clients. So any chance of it being for new farmers or to help-FmHA farmers guarantee, we are a long way down the line.

Mr. PAIGE. Many banks are using this, and this program is for a lot of folks, the ones that are in debt already with the banks, they are going and using this to restructure those debts. The farmer nets nothing in a lot of cases. It is just another bailout for the banks. And I think you need to examine that because, you know, a lot of that is happening throughout the country.

Senator CONRAD. All right. Gene.

Mr. SEVERENS. Well, and Jerry may have more to say about this, but to me, I look at Farmers Home to sort of simplify the components of Farmers Home. I see Farmers Home having a front door, an exit door, and a program in between. And the front door is determined by your eligibility requirement and loan ceilings. And it is important to know who it is we are trying to help. That is the front door. And as soon as they come in the front door, the program that you put in place, the type of assistance that you offer them has got to have that person headed toward the exit door.

I mean the idea is for Farmers Home—I mean I agree with the assumption that Farmers Home should not be a permanent lender for years upon years. And one of the reasons I am forced to come to that conclusion—there is a lot of good reasons—but one of them is simply a fiscal reason. There is only so much, there is a finite amount of money, and we have to bring that money back to the front door to create new opportunities and let new borrowers enter in and have access to FmHA assistance.

Once we know what that front door is then we have to wrestle with what that program content should be, and I think that guaranteed lending, to answer your question more directly, you know, there may be some ways to devise it. But until, maybe some experimentation, maybe some demonstration projects of some type could be done to try to make guaranteed loan lending work. I agree with the people on the panel that guaranteed lending as it currently exists will not serve what I think the proper purpose of Farmers Home should be, and that is why our position is basically to retain direct lending, return it even back to earlier levels until we are confident that we have some type of guaranteed lending that can do the job that direct lending has done so well over the past few decades.

That is not to say that it might not work and there might not be some things that are worth trying to see if there are some new financial devices out there that can solve the sort of budgetary scoring problems on the one hand, and yet do it in such a way and take advantage of commercial credit, and yet not do it in such a way that we simply abandon, zero out the public purpose of the agency.

Senator **Conrad**. All right.

Mr. **Paige** I would like to say if the guaranteed loan is the way we plan to go, we do not need it as far as our constituency is concerned. But if the transition is made, we need to target it for minority participation to make sure that the people who need it the most can get it.

Senator **Conrad**. Let me ask you this. Would Norwegians qualify?

Mr. **Paige**. Sure. [Laughter.]

But we need to make sure that any program like this has targeting for minorities.

Senator **Conrad**. Yes.

Ms. **Baldwin**. Mr. Chairman, the bottom line is that a farmer cannot work his way out of borrowing until our loan rates are such that they cover not only cost of production but a small profit. Just covering the cost of production will only allow us to pay back that year, and until we get out of the mind set and the banks have it, too, because they want us to borrow money, but now they make it impossible for us to continue farming. I really do not understand FmHA's mind set. I have a feeling that they are not thinking about the fact that they might be putting themselves out of business, and then there will be an awful lot of people that will not have jobs anymore. It will save the forests, however, because of the paper trail that FmHA leaves.

But the thing is until—and you are one of the Senators that is unhappy with Clayton Yeutter's proposal on what we do with our farm prices—but until that is solved, it will not solve our credit problems. The Credit Act was a mandate.

Senator **Conrad**. You have income. You have to have income, right?

Ms. **Baldwin**. Yes.

Senator **Conrad**. That is the bottom line. Ms. Cook, did you want to add something to this?

Ms. Cook. Not really. I think it has already been better said than I could say it, but I never miss an opportunity to throw in two cents. I would encourage you to run this past some of the banking community because they were coming to us at prior levels of downpayment and equity requirements and saying we cannot work with this.

Senator Conrad. Yes.

Ms. Cook. And now Farmers Home is raising those requirements and at the same time beginning to limit what their guarantee level is going to be.

Senator Conrad. Right.

Ms. Cook. I do not see that this program is going to work.

Senator Conrad. Well, one of our upcoming hearings is going to give an opportunity to the banking community to come in and speak on this very subject. Frankly, I think it is a very dangerous thing to jump from one moving train on to another one without knowing what the destination is. And not even knowing if there is any track ahead. The thing that causes me the greatest concern here is I have no confidence that this is a program that is going to work. I have no confidence it is going to deal with the same group of people that we are dealing with in the direct loan program. Further, I have no confidence that the banking community is going to be terribly attracted to picking up many of these folks that are now in the direct lending program.

I mean my conversations with bankers have told me that they are not terribly enthusiastic of being lenders of last resort. That is FmHA's traditional role, and that does take us to the whole question of graduation. And I wanted to thank Eugene and your group very much for the contribution you have made there. I think it is an important one.

Mr. Paige. It also could have an adverse effect on the smaller banks in smaller communities because you have just so much resources there. And if you make a new loan, to loan 20 farmers at $150,000, $100,000 or $50,000, you know, what happens to the bank's ability to service the need of an entire rural community?

Senator Conrad. Yes, there is a real circular effect here. I can tell you in my State we have the S&L crisis as well. We have just had the S&L that was the biggest farm lender of the banking community close its doors. And REFCORP has taken over, and REFCORP says they are not going to be an ag lender. And so now you have more pressure on the direct lending capacity of the credit system in the State, and we have an administration proposal that says reduce direct lending, increase the guarantees, when the evidence would suggest that those who are in direct lending programs will not make the transition very easily to guarantees. So there is a whole circular effect here that we have to be sensitive to when we write legislation.

I am going to have to close the hearing, given the lateness of the hour.

I once again want to thank everyone for your patience, your cooperation, and your contribution because it has been an important assist to the committee and to the work of Congress. Thank you very much.

[Whereupon, at 5:40 p.m., the subcommittee recessed, to reconvene at 2:36 p.m., Tuesday, February 20, 1990, in room SR-332, Russell Senate Office Building.]

PREPARATION FOR THE 1990 FARM BILL

Credit Title of the 1990 Farm Bill As It Relates to the Farmers Home Administration's Guaranteed Loan Program

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TUESDAY, FEBRUARY 20, 1990

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL CREDIT OF THE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:36 p.m., in room SR-332, Russell Senate Office Building, Hon. Kent Conrad (chairman of the subcommittee) presiding.

Present or submitting a statement: Senators Conrad, Boschwitz, and Gorton.

STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. The hearing before the Subcommittee on Agricultural Credit will come to order.

This hearing is on the credit title of the 1990 farm bill as it relates to the Farmers Home Administration and specifically the guaranteed loan program.

I have a statement that I will enter into the record, but in the interest of time I will not present the whole statement.

I will just indicate that we have completed two hearings on the credit title now and it is, I think, becoming more and more clear that there are some problems with moving completely from a direct lending program to guarantees, and moving as quickly as we are. I heard this at the hearing held in Bismarck, a lengthy hearing with virtually all of the constituency groups represented, as well as at the first hearing here in Washington.

We heard concern that if we have as dramatic a drop in direct loans as is being proposed, there are going to be a substantial number of borrowers who will not qualify for guarantees. A second issue that was raised was the question of the proposed interest assistance program. The point was made that it is certainly a helpful thing, a useful thing, but 3 years of interest reduction does not sufficiently reduce the amount outstanding on the loan to assure that loan will then be bankable at commercial interest rates and terms.

We heard this, I might say, from not only private sector bankers, but the head of the North Dakota Farm Bureau, as well as the

State director of FmHA. They are concerned that there is not a perfect fit between those who would qualify for guaranteed lending program and those who would quality for direct lending.

In addition, concern was expressed at that hearing on the 7-year limitation on the graduation program. There was a strong sense that there ought to be some process for graduation, but a concern that at the end of 7 years, people may not be ready. And again, that was expressed by virtually all of the witnesses.

So there was an interest in moving forward and dealing with the problems that have been identified with FmHA lending, an interest to not just stay with the status quo, and at the same time there was a kind of cautionary signal about some of the proposals that are before us. There were some suggestions that we ought to try at least part of these proposals on an experimental basis only to see how well they work before we jump completely into the camp of counting on them to work.

Also I must say there was a concern about credit availability this planting season, more of a concern than I had heard previously. A lot of people indicated that with the current climate, folks are not showing payability, not showing that they can cash-flow, even with the assumption of a normal crop. That is not even with the assumption that we are going to have a third year of drought.

I want to alert the people who are in the credit community that a deep anxiety exists out across my State, at least with the prospects for a lack of moisture, virtually no precipitation this winter and very serious concern as to what that portends for the spring. With that I will enter my statement into the record and turn to my colleague, Senator Boschwitz for any opening statement he may have.

[The prepared statement of Senator Conrad follows:]

PREPARED STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Good afternoon and welcome to the third hearing [6] of the Subcommittee on Agricultural Credit on the credit title of the 1990 farm bill as it relates to the Farmers Home Administration.

Today we continue our process of reviewing FmHA's programs by examining FmHA's guaranteed lending program. The purpose of this hearing is to address the problems and the successes with the program. How well does the guaranteed program serve FmHA's mission to be lender of last resort to assist the beginning and financially distressed farmer? What changes are needed to expand the use of the program? How can we ensure that FmHA improves its processing and oversight of these loans so that losses under this program do not increase, as some have predicted?

The 1985 farm bill mandated a shift from direct to guaranteed loan funding for FY 1985–88. While there has been no specific authorizations for direct and guaranteed loans in the last 2 years, Congress has continued that shift through its appropriations. Funding for direct loans has dropped 77 percent since 1985, and authorizations for guaranteed loans have more than doubled.

Despite significant authorizations, the guaranteed lending program has not been fully utilized. Only 35 percent of the $3.3 billion authorized in FY 1989 was obligated. In 1989, FmHA received three times the number of applications for direct loans as for guaranteed loans. Because these funds were not fully used, and because of the severe drop in direct loan funding, this shift in funding has resulted in a 65 percent drop in Operating Loans made by FmHA, and a 59 percent drop in Farm Ownership loans made. These statistics have led me to question whether the guaranteed lending program can fully replace the cut in direct loan funds.

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[6] The second hearing held on February 13, 1990, "FmHA Issues Relating to the Credit Title of the 1990 Farm Bill," the Heritage Center Auditorium, Bismarck, ND, at 9:30 a.m., and chaired by Senator Conrad. This hearing was not printed and is retained in the subcommittee file.

The testimony that I have heard at my last two hearings tells me that, in fact, guaranteed loans cannot fully replace direct loans. Today we will discuss just how much of the credit gap can be filled by guaranteed loans, and how to improve the guaranteed loan program to make it reach its full potential.

I am also concerned about allegations of abuses of the guaranteed lending program, particularly by lenders. In some of those instances, FmHA has discovered the abuse and refused to honor its guarantee, which prevents losses to the Federal Government. However, in many of these cases, the borrower loses because his loan is liquidated.

I therefore want to discuss FmHA's oversight of this program and its ability to prevent abuses. What can it do when it discovers abuses? How effective and how thorough is FmHA's verification of financial data on guaranteed applications? In addition, I want to make sure that FmHA closely oversees the lender's servicing of guaranteed loans to ensure that borrower's financial problems are identified early and resolved through prompt and effective loan servicing when necessary. I also hope to briefly discuss borrowers' rights under the guaranteed lending program.

The guaranteed lending program can serve to assist FmHA direct loan borrowers to graduate, to help beginning farmers obtain private credit, and to aid financially troubled borrowers find credit. I would like to see the program used for these important purposes. However, I want the assurance the FmHA is carefully overseeing these loans to prevent abuses from occurring.

I'd like to thank the witnesses for coming today. Let us begin.

Senator BOSCHWITZ. Mr. Chairman, thank you very much. I have no opening statement. I spoke at the last committee hearing on February 8. I'm on a rather short timeframe but would like to hear as many of the witnesses as possible.

Senator CONRAD. I think we could do that. In fact we have had to make an alteration in the schedule, Senator Boschwitz. We have to take the bankers first because of airline schedules and so the——

Senator BOSCHWITZ. We're going to have a vote in 35 minutes. I am not sure I will be able to come back.

Senator CONRAD. All right. We will take the bankers' panel first, so that they can make it to their airplane appointments. That panel would be Michael Grove, the chairman of the Executive Committee of the Agricultural Bankers Division of the American Bankers Association; Gary Nelson of the Independent Bankers Association of America and president of the Scandia American Bank in Stanley, North Dakota; and Larry Buegler, the Farm Credit Council president and chief executive officer of Farm Credit Services of St. Paul.

If all three of you would join us at the table, we will hear your testimony and then we will go to the panel that would include Neal Sox Johnson, the Acting Administrator of Farmers Home; John W. Harman, the General Accounting Office; and Randi Roth, Farmers' Legal Action Group.

We were able to advise the other panel members of this change, I think. Is this going to work out all right? Thank you very much for your courtesy. Why do we not start, Mr. Grove? We will go through all the witnesses, hear your testimony, and that way Senator Boschwitz will have maximum opportunity to hear testimony. Welcome.

STATEMENT OF MICHAEL GROVE, CHAIRMAN, EXECUTIVE COMMITTEE, AGRICULTURAL BANKERS DIVISION, AMERICAN BANKERS ASSOCIATION AND PRESIDENT, FIRST NATIONAL BANK, WHITE SULPHUR SPRING, MT

Mr. GROVE. Thank you, Mr. Chairman.

INTRODUCTION

I am pleased to be here to participate in this hearing on behalf of the American Bankers Association (ABA). I am Michael Grove, president of the First National Bank of White Sulphur Spring, Montana, and I am also chairman of the ABA's Executive Committee for Agricultural Bankers.

Our association's members represent about 95 percent of the industry's total assets, including 5,000 agricultural banks. Approximately 85 percent of our members are community banks with assets of less than $100 million.

Mr. Chairman, I have prepared a statement for the subcommittee addressing the issue before us today which I will submit. In the interest of time and with your concurrence, I will sort of brief this and I just have some notes about what we have here today.

FMHA GUARANTEE PROPOSAL

As far as the FmHA guarantee proposal, the ABA continues to support the Administration's policy of shifting from direct to guaranteed loans for farm lending. FmHA Federal loan guarantees offer an excellent way to allow banks to provide credit necessary to build a diversified economic base in rural areas while at the same time protecting the financial integrity of the banks.

The ABA believes that the FmHA interest rate buy-down program coupled with the Federal guarantee as submitted by the USDA in its 1991 budget proposal has the potential to enhance greatly the reduction of existing FmHA direct borrowers to the private sector. A Federal guarantee allows a bank to extend credit to a borrower who might otherwise not have the necessary collateral to secure the loan to the satisfaction of the bank regulators. At the same time, Federal assistance on the interest rate enables borrowers whose financial conditions are improving to graduate from direct lending while maintaining manageable payments.

While guaranteed loans made to local lending institutions make for a more appropriate way to provide credit, I do not believe that this approach can completely eliminate the needs for FmHA direct lending programs. As the lender of last resort, FmHA must continue to provide funds for borrowers who may otherwise fall through the cracks.

The ABA is encouraged by Farmers Home Administration's intention to work with commercial lenders in developing underwriting forms, standards, practices and terminology consistent with the private sector. Working with the bankers should help to straighten out some of the problems bankers have been having in parts of the country regarding loan processing, servicing, and liquidation.

BANK REGULATION

I would like to take a minute and talk about bank regulation. Banks must operate within the parameters of safety and soundness laid out by bank regulators. I want to stress this point because bankers are sometimes accused of lacking concern for those who wish to borrow, but lack collateral and/or adequate cash-flow.

The banking regulatory system of this country is designed to protect banks' depositors. To do that, the regulators examine our loans very carefully to be certain that they are adequately secured with an appropriate cash-flow. If the regulators determine that a banks' loans are not of sufficient quality to protect the safety and soundness of the institution, they classify them as substandard. A number of classified loans can lead to very negative consequences for the banks' management and directors. The bank may not survive.

While guarantees often satisfy the risk concerns of the bank regulatory people, they do not always ensure participation.

Policies instituted by FmHA to guard against unwanted defaults can effectively discourage participation in a guaranteed loan program by farmers and commercial banks. For example, last year FmHA instituted a policy requiring farmers to show 110 percent cash-flow as a condition of a loan guarantee approval. Such a restrictive standard is more stringent than the local banks apply to their own customers and hinders the movement of FmHA borrowers to the private sector. This standard should be revised back to the original 100 percent cash-flow provision.

Another problem is how FmHA handles payment on its guaranteed loans. We encourage similar rules, proven to be effective by the SBA, be adopted by FmHA for liquidation.

RURAL DEVELOPMENT

Mr. Chairman, while I understand that one of the reasons for holding this hearing is to find solutions to the FmHA program abuses and to discuss the Administration's proposal, I must note that the problems plaguing FmHA are indicative of the larger problems in rural America. We are concerned about the current situation. For example, I am from a rural community of 1,500 and a county of 2,500 in rural Montana. Despite the serious efforts that I have seen my community make and in which my bank has participated, I see a continued erosion of population and economic activity. Agricultural credit is only one aspect of the total picture.

Polices which encourage public and private investment in rural America are a vital ingredient in rebuilding the economic base of farm communities.

FmHA loan guarantees can be designed to suit various types of rural community and business needs, not just for farm loans or housing loans.

In fact, local bankers support the FmHA's Business and Industry, the B&I guaranteed loan program for rural businesses. A recent example of the use of this program was for businesses affected by the drought authorized by the recent Disaster Assistance Act. In recent years, the B&I allocation has been fully expended within the first few months of each fiscal year. Unfortunately, the B&I

guarantee program is proposed to be terminated by the Administration. The ABA believes that the program not only should be maintained, but it should be expanded in terms of guaranteed funds provided.

The ABA would also like to see the same type of interest rate buy-down program for B&I loans that FmHA is proposing now for farm loans. We also encourage an expansion of the program through lower loan limits of the B&I program.

Mr. Chairman, the events of the 1980's have clearly demonstrated that the health of a bank is inexorably linked to the vitality of its local community. We live there, invest there, and our future is there. Furthermore, the community bank typically now has a low loan-deposit ratio and has money to lend to build their community. The banking industry, therefore, has an important stake in strengthening and diversifying the economic base of the small towns and rural areas across America. Bankers offer knowledge of local character, markets, financial expertise, and have a serious commitment to the revitalization of rural America. We look forward to working with you and your colleagues as you examine Federal programs, such as FmHA, in an effort to make them a more integral part of rural development solution. Thank you. I would be pleased to respond to any questions.

[The prepared statement of Mr. Grove follows:]

STATEMENT

OF

THE AMERICAN BANKERS ASSOCIATION

ON

THE FARMERS HOME ADMINISTRATION

PRESENTED

TO

THE SENATE AGRICULTURAL SUBCOMMITTEE ON AGRICULTURAL CREDIT

BY

MICHAEL GROVE

FEBRUARY 20, 1990

Mr. Chairman and Members of the Committee, I am pleased to be here to participate in this hearing on behalf of the American Bankers Association (ABA). I am Michael Grove, President, First National Bank, White Sulphur Spring, Montana, and I am a Chairman of the Executive Committee of the Agricultural Bankers Division of the ABA.

Our Association's members represent about 95 percent of the industry's total assets, including 5,000 agricultural banks. Approximately 85 percent of our members are community banks with assets of less than $100 million.

FmHA Guarantee Proposal

We must look carefully at what the real problems are in rural areas as we seek to develop solutions. If we want to lend money to beginning farm borrowers without collateral or experience as a public policy, then we should look at the appropriate mechanisms to do that while continuing to protect the safety and soundness of our commercial banks. One solution that should be thoroughly examined and considered is the modified FmHA guaranteed loan program introduced recently by USDA in the Fiscal Year 1991 Budget.

The ABA continues to support the Administration's policy of shifting from direct to guaranteed loans for farm lending. FmHA federal loan guarantees offer an excellent way to allow banks to provide the credit necessary to build a diversified economic base in rural areas while at the same time protecting the financial integrity of the banks. Our association has consistently supported limiting the use of direct federal loans, believing instead that guaranteed loans made through local lending institutions make for a more appropriate way to provide credit.

The ABA believes that the FmHA interest rate buy-down program coupled with a federal guarantee as submitted by USDA in its 1991 Budget proposal has the potential to enhance greatly the graduation of existing FmHA direct borrowers to the private sector. A federal guarantee allows a bank to extend credit to a borrower who might otherwise not have the necessary collateral to secure the loan to the satisfaction of bank regulators. At the same time, federal assistance on the interest rate enables farmers whose financial conditions are improving to graduate from direct lending while maintaining manageable payments.

In addition, the FmHA proposal offers a potentially workable solution to administrative difficulties between some local banks and FmHA County supervisors resulting from confusions over such things as loan processing, terminology, and underwriting forms. The ABA is encouraged by Farmers Home Administration's intention to work with commercial lenders in developing underwriting forms, standards, practices and terminology consistent with the private sector. Such a good faith effort in developing uniformity should help to streamline the loan application and loan management process.

Bank Regulation

Local banks have a major stake in the economic health of their customers, and they are uniquely qualified to meet most of the credit needs of their communities. But banks must also operate within the parameters of safety and soundness laid out by bank regulators. I want to stress this point because bankers are sometimes accused of lacking concern for those who wish to borrow but lack collateral and/or adequate cash flow.

The banking regulatory system of this country is designed to protect banks' depositors. To do that, the regulators examine our loans very carefully to be certain that they are adequately secured with an appropriate cash flow. If the regulators determine that a banks' loans are not of sufficient quality to protect the safety and soundness of the institution, they classify them as substandard. A number of classified loans can lead to very negative consequences for the banks' management and directors. The bank may not survive.

We should not simply assume that our existing institutions do not want or are not able to achieve the public policy goal of providing capital or loans to beginning farms and businesses in rural areas. There are impediments to some of this involvement that result from bank regulation. Therefore, we must identify carefully the goal that we seek and then look for appropriate means to achieve it. As we do this, we should not ignore the safety and soundness of our financial institutions. While guarantees often satisfy the risk concerns of the bank regulators, they do not always ensure participation.

This point brings me to one troubling FmHA policy that effectively discourages participation in the guaranteed loan program by farmers and commercial banks. Last year, FmHA instituted a policy requiring farmers to show 110 percent cashflow as a condition for loan guarantee approval. Such a restrictive standard -- more stringent, I may add, than commercial banks apply to their own customers -- hinders the movement of FmHA direct borrowers into the private sector and limits access by financially stressed borrowers to FmHA guarantee loan programs. Common sense suggests that if the stated objective of the Farmer Home Administration is to move toward more private source lending that they would revise this unrealistic requirement that effectively pushes additional farmers either to the direct loan program or out of business.

Rural Development

Mr. Chairman, while I understand that one of the reasons for holding this hearing is to find solutions to FmHA program abuses and to discuss the Administration's proposal, I must note that the problems plaguing FmHA are indicative of the larger problems in rural America. We are concerned about the current situation. For example, I am from a rural community of 1,500 and a county of 2,500 in rural Montana. Despite the serious efforts that I have seen my community make and in which my bank has participated, I see a continued erosion of population and economic activity. The point I am trying to make is that ABA recognizes that the problems facing rural communities are interconnected. In addition to agriculture, education, health care facilities, infrastructure systems and other factors are very much a part of any rural community. Credit is only one aspect of the total picture.

Rural communities -- especially these heavily dependent on agriculture -- are going through a period of wrenching change. As employment opportunities disappear, skilled workers and the young are migrating from rural to urban areas in search of jobs. Local government in agricultural areas are faced with reduced tax bases and deteriorating infrastructures. The magnitude and intransigence of these problems have all been well documented.

There may be relief. Experts in agricultural economics believe that the farm sector is stabilizing. However, the severity of the recent cyclical downswing of U.S. agriculture (which is reflected in the losses being reported by FmHA) taught us a valuable lesson about the need for economic diversification in our rural communities. Without diversification, we will remain extremely vulnerable to future fluctuations in the farm economy. Economic diversification will not be easy to achieve.

Policies which encourage public and private investment in rural America are a vital ingredient in rebuilding the economic base of farm communities. As the basic comprehensive financial intermediaries in rural areas, banks must play a central role in this investment process by providing credit to encourage diversification in agricultural production, to assist new businesses, and to find improvements in education and community infrastructure.

FmHA loan guarantees can be designed to suit various types of rural community and business needs, not just for farm loans or housing loans.

Local bankers support the Farmers Home Administration's Business and Industry (B&I) guaranteed loan program for rural businesses. A recent example of the use of this program was for businesses affected by the drought authorized by the recent Disaster Assistance Act. In recent years, the B&I allocation has been fully expended within the first few months of each fiscal year. Unfortunately, the B&I guarantee program is proposed to be terminated by the Administration. We believe that the program not only should be maintained, but it should be expanded in terms of guaranteed funds provided.

In addition, the FmHA Approved Lender Program for Farm Programs should be modified to create a certification process for both farm and B&I loans that will streamline the servicing and processing of guaranteed loans. With careful design, the American Bankers Association believes that banks can participate and handle all paperwork including the processing, closing, servicing, and, if necessary, the liquidation of FmHA loans in a manner similar to the authority granted commercial banks through the Small Business Administration.

Mr. Chairman, the events of the 1980s have clearly demonstrated that the health of a bank is inexorably linked to the vitality of its local economy. The banking industry, therefore, has an important stake in strengthening and diversifying the economic base of the small towns and rural areas across America. Bankers offer knowledge of local markets, financial expertise, and a serious commitment to the revitalization of rural American. We look forward to working with you and your colleagues as you examine federal programs, such as FmHA, in effort to make them a more integral part of the rural development solution. I would be pleased to respond to questions.

Senator **Conrad**. Thank you very much, Mr. Grove. Mr. Nelson, we will proceed with you. Gary, welcome. Always good to have you here, and let me just say that Gary Nelson is an independent banker in my State who has shown a very genuine concern for his farm borrowers. I think that clearly indicated his willingness to try to work with them through a very difficult time. And if there is anything to test producers and bankers, it is 2 years of drought, heading into a third year. Nobody knows that better than Mr. Nelson, who runs a bank that is right in the middle of the area most affected. With that, again, welcome, Gary, and proceed with your testimony.

Senator **Boschwitz**. Where is Stanley?

Senator **Conrad**. In the western part of the State west of Minot.

Mr. **Grove**. We are right in the center of the State.

STATEMENT OF GARY S. NELSON, PRESIDENT, SCANDIA AMERICAN BANK, STANLEY, ND; TESTIFYING ON BEHALF OF INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. **Nelson**. Thank you, Mr. Chairman. Thank you for your cautious previous comments in the opening testimony.

INTRODUCTION

Mr. Chairman and members of the subcommittee, my name is Gary Stanley Nelson. I am the president of the Scandia American Bank in Stanley, North Dakota. Incidentally a community of 1,500 people. I am also on the Board of Directors of the Independent Bankers Association of America (IBAA), as well as on their Policy Development Committee. It is on behalf of the IBAA that I appear before you today.

I welcome this opportunity to present comments on the credit title of the farm bill, and more specifically, the Farmers Home Administration's (FmHA) guaranteed loan program.

First of all, let me thank you for the opportunity to appear before this distinguished panel. It is especially gratifying to see a good friend and a fellow North Dakotan in the Chair. As the chairman well knows, few subjects are more important to our State of North Dakota than the availability of agricultural credit, and few subjects are more important to the members of the Independent Bankers Association of America.

The IBAA is an organization of independent community banks, locally owned and operated, dedicated to meeting the financial needs of their communities. IBAA and its members believe these banks are better able to serve their communities than financial systems which follow policies that are not set locally and thus may not meet local needs.

IBAA is the ONLY national trade association dedicated exclusively to representing the views and interests of locally owned and operated community banks.

Currently, IBAA has about 6,300 member banks, roughly half of all the banks in the country. About 40 percent of IBAA member banks are agricultural banks, although virtually all of them are involved in some aspect of agri-business or agricultural credit. It almost goes without saying that our member banks are typically small, with about 90 percent having less than $100 million in assets. Despite their lack of size, their communities depend on them to provide safe, sound, and accessible financial services for residents and small businesses alike.

THE IBAA DOES NOT SUPPORT PHASING OUT THE DIRECT FARM LENDING PROGRAMS OF THE FARMERS HOME ADMINISTRATION

Mr. Chairman, let me begin my testimony by stating, just as emphatically as I can, that the IBAA does NOT support phasing out the direct farm lending programs of the Farmers Home Administration (FmHA). Nor does it support the concept of using guaranteed loan programs to replace the direct loan program. To the extent that the administration's budget and farm bill proposal seek to do this, we are opposed.

As community bankers who must adhere to strict safety and soundness principles, we cannot, by definition, become the "lender of last resort." We believe that FmHA must continue to fulfill that role, particularly for farmers in need of supervised credit and those with no established credit or farming history.

THERE IS MUCH THAT IS MERITORIOUS IN THE ADMINISTRATION'S FARM BILL PROPOSAL ON AGRICULTURAL CREDIT

Having said that, let me add that there is much that is meritorious in the Administration's farm bill proposal on agricultural credit. Let me address a few of those specific areas.

We appreciate and understand the Administration's desire to limit direct farmer program loans to existing borrowers and beginning farmers. However, we believe there are and there will continue to be farmers who have proven management capability, but who through no fault of their own may need access to some form of FmHA credit. We believe the FmHA farm lending program must provide for these kinds of situations.

We support targeting scarce Federal dollars where they are most needed, and we believe proper screening techniques and eligibility criteria will help support this.

Additionally, while we favor the concept of limiting the amount of time a borrower could stay with the Farmers Home Administration, we are concerned that legislating a specific number of years may not be a feasible approach. Invariably, a borrower who is engaging in a successful farming operation will fall through the cracks due to an unforeseen situation that may involve a family emergency, a freak hail storm, or any number of possibilities. We feel that provisions must be made for this type of contingency to give these farmers a chance to recover. We would rather see a limitation handled through administrative means, so that exceptions can be granted if required and if necessary.

We support the Administration's desire to accelerate graduations to commercial credit through the use of unilateral risk-based interest buy downs, and we applaud the decision to terminate the requirement for bank participation in this program. We believe this approach will make the buy down program much more attractive for community banks.

We were also pleased with the administration's proposal to use underwriting forms, standards, practices and terminology consistent with the private sector to the maximum extent possible. As the chairman well knows, this is an area where IBAA has been particularly active in working to achieve a level of uniformity that would streamline the paperwork process. The Administration's proposal is definitely a step in the right direction.

We support the Administration's proposal to amend the Agricultural Credit Act to allow Farmer Mac to pool FmHA guaranteed loans. From the standpoint of consistency and efficiency, we believe that a single secondary market for all agricultural and rural lending programs makes more sense than having both a Farmer Mac and, if you will, an Aggie Mae adding more confusion to an already confusing situation.

With particular reference to the guaranteed lending programs, let me first of all commend the Congress and FmHA for implementing this program when it did—during the farm crisis of the 1980's. The FmHA guaranteed loan program played a significant role in helping community banks to restructure troubled loans, and our segment of the financial community was without question well served by this program. I think it is fair to say that during these difficult years, the guaranteed loan program contributed substantially to keeping a number of banks afloat, agriculture banks, that might have otherwise gone under.

Where properly managed and with legitimate lending criteria, the FmHA guaranteed loan program can be cost-effective and not constitute a drain on the Federal budget.

We support Administration efforts to facilitate the transition of FmHA guaranteed loans to the private sector by imposing limits on both the eligibility and terms of the loans. We feel it is very important for the FmHA borrower to know up front that FmHA is a short-term lender, and ultimately, they will have to graduate to commercial credit. However, we have the same concern about legislating a specific number of years in this area as we did in the direct loan area. We would much rather see this handled administratively.

Senator BOSCHWITZ. Mr. Chairman, I do not mean to cut this witness short at all, but he has been going on for 10 minutes and I see he has another 10 minutes left. May I ask if the chairman would object if the witness were to summarize the balance of his statement?

Senator CONRAD. No, that would be fine. If you can do that, we will include the full written statement in the record. What Senator Boschwitz is concerned about is we have a vote at 3:15 and I think he would like to have a chance to introduce Mr. Buegler and hear his testimony as well. So if you can summarize your testimony, we will include the full statement in the record.

Mr. NELSON. All right. Thank you very much Mr. Chairman and Senator Boschwitz.

CONCERNS

At the risk of sounding a discordant note in an otherwise supportive statement, let me brief through the next few points that we feel need to be addressed.

Concerning Farmers Home Administration's structure in handling its guaranteed loans. We independent bankers have no problem with dealing with those loans on a local supervisory level in the county. Where the bottleneck oftentimes occurs is that level beyond the local level. It seems to be happening in getting loans approved.

The second area of concern and that is the "approved lender" status. Oftentimes, there is not a whole lot of difference between those banks that have an approved lender status and those banks that do not. We would appreciate having Congress look at that so that if a bank is given approved lender status, it does mean something like eliminating paperwork and streamlining the process.

A third concern, Senators, and that is the overzealous, not all the time, but oftentimes on behalf of the Farmers Home Administration in their requiring the crossing of t's and dotting of i's of not honoring the guarantee. Should there be an error made somewhere through the process or somewhere through the handling of the loan, the FmHA will not honor its guarantee, but find some loophole or find somewhere in which to not honor either the guarantee or part of the guarantee. We feel that if the mistake is not substantial as far as the loan is concerned, we think that this should be a rule of reason.

And number four, very quickly, we are troubled by what appears to be a "dumping" on the Farmers Home Administration system in its guaranteed loan portfolio. We would ask that Congress would look at this matter very carefully, so that institutions out there in the country do not use FmHA for other purposes than what it was truly intended for.

CONCLUSION

In closing, folks and Senators and this subcommittee, let me again thank you and ask that you consider this testimony given on behalf of the IBAA. As a closing statement, I would ask that although this does not directly relate to the FmHA farm program, please give attention to those lower prices and those target prices that are often set far beyond those that will either benefit or will not benefit. For if the farmer cannot somehow get a return on the commodity in which we are financing and which the farmer is growing, all this maybe very futile to say the least.

Thank you very kindly. I will be happy to answer any questions.

[The prepared statement of Mr. Nelson follows:]

Statement of

GARY S. NELSON, PRESIDENT
SCANDIA AMERICAN BANK
STANLEY, ND

On Behalf Of

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Before The

SENATE AGRICULTURE, NUTRITION AND FORESTRY COMMITTEE
AGRICULTURAL CREDIT SUBCOMMITTEE
WASHINGTON, D.C.

February 20, 1990

Mr. Chairman, Members of the Committee, my name is Gary S. Nelson. I am President of the Scandia American Bank in Stanley, North Dakota, and also on the Board of Directors and the Policy Development Committee of the Independent Bankers Association of America (IBAA). It is on behalf of the IBAA that I appear before you today.

I welcome this opportunity to present comments on the credit title of the Farm Bill, and more specifically, the Farmers Home Administration's (FmHA) guaranteed loan program.

First of all, let me thank you for the opportunity to appear before this distinguished panel. It's especially gratifying to see a good friend and fellow North Dakotan in the Chair. As the Chairman knows, few subjects are more important to our state of North Dakota than the availability of agricultural credit, and few subjects are more important to members of the Independent Bankers Association of America.

The IBAA is an organization of independent community banks, locally owned and operated, dedicated to meeting the financial needs of their communities. IBAA and its members believe these banks are better able to serve their communities than financial systems which follow policies that are not set locally and thus may not meet local needs.

IBAA is the ONLY national trade association dedicated exclusively to representing the views and interests of locally owned and operated community banks.

Currently, IBAA has about 6,300 member banks...roughly half of all banks in the country. About 40 percent of IBAA member banks are agricultural banks, although virtually all of them are involved in some aspect of agri-business or agricultural credit. It almost goes without saying that our member banks are typically small, with about 90 percent having less than $100 million in assets. Despite their lack of size, their communities depend on them to provide safe, sound and accessible financial services for residents and small businesses alike.

Mr. Chairman, let me begin my testimony by stating, just as emphatically as I can, that the IBAA does NOT support phasing out the direct farm lending programs of the Farmers Home Administration (FmHA). Nor does it support the concept of using the guaranteed loan program to replace the direct loan program. To the extent that the Administration's budget and farm bill proposal seek to do this, we must oppose it.

As community bankers who must adhere to strict safety and soundness principles, we cannot, by definition, become the "lender of last resort." We believe that FmHA must continue to fulfill that role, particularly for farmers in need of supervised credit and those with no established credit or farming history.

Having said that, let me add that there is much that is meritorious in the Administration's farm bill proposal on agricultural credit. Let me address some specific areas now.

* We appreciate and understand the Administration's desire to limit direct farmer program loans to existing borrowers and beginning farmers. However, we believe there are and will continue to be farmers who have proven management capability, but who through no fault of their own may need access to some form of FmHA credit. We believe the FmHA farm lending program must provide for these kinds of situations.

We support targeting scarce Federal dollars where they are most needed, and believe proper screening techniques and eligibility criteria will help to do this.

Additionally, while we favor the concept of limiting the amount of time a borrower could stay with FmHA, we are concerned that legislating a specific number of years may not be a feasible approach. Invariably, a borrower who is engaging in a successful farming operation will fall through the cracks due to an unforeseen situation that may involve a family emergency, a freak hail storm, or any number of possibilities. We feel that provisions must be made for this type of contingency to give these farmers a chance to recover. We would rather see a limitation handled through administrative means, so that exceptions can be granted if required.

* We support the Administration's desire to accelerate graduations to commercial credit through the use of unilateral risk-based interest buy downs, and we applaud the decision to terminate the requirement for bank participation in this program. We believe this approach will make the buy down program much more attractive for community banks.

* We are pleased with the Administration's proposal to use underwriting forms, standards, practices and terminology consistent with the private sector to the maximum extent possible. As the Chairman well knows, this is an area where IBAA has been particularly active in working to achieve a level of uniformity that would streamline the paperwork process. The Administration's proposal is definitely a step in the right direction.

* We support the Administration's proposal to amend the Agricultural Credit Act to allow Farmer Mac to pool FmHA guaranteed loans. From the standpoint of consistency and efficiency, we believe that a single secondary market for all agricultural and rural lending programs makes more sense than having both a Farmer Mac and an Aggie Mae adding more confusion to an already confusing situation.

* With particular reference to the guaranteed lending programs, let me first of all commend the Congress and FmHA for implementing this program when it did -- during the farm crisis of the 1980's. The FmHA guaranteed loan program played a significant role in helping community banks to restructure troubled loans, and our segment of the financial community was without question well served by this program. I think it's fair to say that during these difficult times, the guaranteed loan program contributed substantially to keeping a number of banks afloat that otherwise might have gone under.

Where properly managed and with adequate lending criteria, the FmHA guaranteed loan program can be cost-effective and not constitute a drain on the Federal budget.

We support Administration efforts to facilitate the transition of FmHA guaranteed loans to the private sector by imposing limits on both the eligibility and terms of the loans. We feel it is very important for FmHA borrowers to know up front that FmHA is a short-term lender, and ultimately, they will have to graduate to commercial credit. However, we have the same concern about legislating a specific number of years in this area as we did in the direct loan area. We would much rather see this handled administratively.

Time will not permit a full discussion of each and every detail of the Administration's farm bill proposal on agricultural credit. However, I think it is fair to say that the IBAA views it as a step in the right direction. We believe that if these proposals are enacted, they will not only go a long way towards returning FmHA to its original mission as the farm lender of last resort, but it will also significantly enhance the viability of the independent banking system, which serves to support and complement the Federal farm lending program.

At the risk of sounding a discordant note in an otherwise supportive statement, let me add that we have several major concerns that we feel must be addressed.

* One concern is the almost unwieldy FmHA field structure, and its ability to work with independent banks on a timely basis. Generally, IBAA member banks have excellent working relationships with FmHA staff at all levels, but particularly at the county supervisor level. And our comments are certainly not intended to cast any aspersions on either the ability or the willingness of FmHA to work with us.

However, we have heard from a number of our member banks that when the loan level exceeds the approval authority of the county supervisor and must go to a higher level, major delays are not uncommon. We urge FmHA to look into the loan approval process above the county supervisor level to see if there is any way to assure more timely handling of the application process.

* We are also concerned about "approved lender" requirements and benefits. Several of our member banks have commented that there seems to be little if any difference in either the time or complexity in getting guaranteed loans approved by banks that are approved lenders versus those that are not. One bank, as an example, had its approved lender status expire, and continued to make guaranteed loans in the same manner as when it was an approved lender.

We believe that if a bank goes to the trouble to qualify as an approved lender, there should be some benefit in the form of reduced paperwork or streamlined procedures. This does not seem to be the case.

* A major concern of the IBAA is the overzealous application of the rules by FmHA staff in dealing with loss claims. A number of our banks have complained that if they made inadvertent technical errors in the loan documentation, FmHA will not honor the loss claim.

We acknowledge that there has to be a set of standards, and we certainly have no quarrel with walking away when there are major substantive errors or a deliberate attempt to defraud. But when minor clerical errors are made, with clearly no intent to cheat the government, we believe that FmHA should apply a rule of reason and and work with the banks to resolve the problem in a fair and equitable manner.

This problem could be largely mitigated if banks had the option to sell guaranteed loans into a Farmer Mac pool, and is another reason for supporting that proposal.

* We are very troubled by what appears to be "dumping" practices by several Farm Credit System institutions which is having the effect of lowering the loan quality in FmHA's guaranteed loan portfolio. We do not believe the guaranteed loan program was enacted to become a dumping ground for nonperforming loans made by FCS land banks, and strongly urge the Congress and the Administration to take steps to put an end to this practice at once.

We encourage the Farm Credit System to concentrate on safety and soundness and in rebuilding its capital base, but certainly not at the expense of the FmHA guaranteed loan program. This is not only unfair to community banks, but does a great disservice to borrowers as well.

In closing, let me once again thank you for this opportunity to present the views of the Independent Bankers Association of America. As a matter of policy, we have encouraged our members to participate in the FmHA guaranteed loan program. In fact, a resolution will be brought before the IBAA Board of Directors at our convention next month which states, in part, "We encourage community banks to be involved in the FmHA guaranteed loan program as a method to better serve their qualified farm customers."

We applaud the Administration's farm bill proposal as a definite step in the right direction, but we add a cautionary note that several major problem areas still exist that could stand in the way of wider use of the FmHA guaranteed loan program by IBAA member banks.

Let me also add that my remarks today were limited to the credit title of the Farm Bill, and more specifically to the FmHA programs. We have not commented on other sections of the bill, and our support for some of the credit proposals may not necessarily reflect our thinking in other areas.

For example, as community bankers, we are very concerned about the issue of maintaining versus lowering target prices. Very briefly, while the IBAA supports the market orientation approach begun by the 1985 Farm Bill, we believe that the Government must make global competitiveness the center piece of any long range proposal. Nothing is more central to this issue than Government support prices, and we will be taking a very close look at this issue and others in the various Farm Bill proposals.

Thank you, again, Mr. Chairman, and I would be happy to try to answer any questions you or other Members of the Committee may have.

Senator CONRAD. Thank you very much, Gary. Senator Boschwitz.

Senator BOSCHWITZ. Mr. Chairman, Larry Buegler was for many years with the Norwest Bank in St. Paul. He distinguished himself there and was then called to the St. Paul District of the Farm Credit System at a very, very difficult time. He really has led it out of an abyss. Senator Boren, who is your predecessor, and I, when I was the Ranking member of this subcommittee, incorporated a great deal of the St. Paul District's approach into the farm credit bailout, for lack of a better word, though it has not cost the Government very much money at all.

Many of his ideas, particularly on restructuring, were adopted and did much to save the Farm Credit System and its borrowers. I hope that you will address, Larry, what the gentleman from the IBAA said about the dumping practices by several Farm Credit System institutions. I hope that that does not include you, and it certainly would not characterize the stewardship that you have had of the Farm Credit System. But we are very pleased to have you here.

STATEMENT OF LARRY BUEGLER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FARM CREDIT BANK OF ST. PAUL, ST. PAUL, MN; TESTIFYING ON BEHALF OF THE FARM CREDIT COUNCIL

Mr. BUEGLER. Thank you, Senator, Mr. Chairman, and other members of the subcommittee.

INTRODUCTION

I am testifying today on behalf of The Farm Credit Council, which is our national trade organization for the Farm Credit System. I am going to speak on three issues that you asked the Farm Credit System to comment. They are:

Views on existing FmHA guaranteed loan programs; recommended changes to current programs to enhance program use; and comments on the Administration's recommendations for revisions to FmHA programs, particularly the spending levels for fiscal year 1991.

BACKROUND

Prior to the Farm Credit System's financial difficulties in the early 1980's, there was not much use of FmHA programs in the System. When the agriculture economy and the environment changed we found that the financial condition of our member borrowers had declined, it became necessary to obtain guarantees to reduce our credit risk, thereby permitting us to continue to finance many distressed borrowers.

Currently all the System banks and almost all the associations qualify for the direct lender program that was previously mentioned. The System has dramatically increased the use of guarantees, and as you heard in North Dakota last week, have increased guarantees by about 193 percent since 1986. (See chart, Total FCB Loan Volume Guaranteed by FmHA on p. 226.)

The St. Paul District has made extensive use of guarantees and are currently writing in excess of 50 percent of all those in the

Farm Credit System. We have a total $334 million of guarantees outstanding to a little over 3,000 farm borrowers in all four States.

Senator BOSCHWITZ. Your district is writing 50 percent. How many districts are there—12?

Mr. BUEGLER. There are 11 districts now with the liquidation of the Jackson Land Bank. Yes, we are writing in excess of 50 percent of all of them. There is no question that the St. Paul District has had a good experience with writing these guarantees.

CONCERNS AND SUGGESTIONS ABOUT FMHA PROGRAMS

And, Mr. Chairman, I want to express our thanks to the hard work of the FmHA county and the State staff in the four States where we operate. Overall, we have found the FmHA staff to be a group of hard-working, sometimes overworked, dedicated people interested in making these programs successful.

I would, also, like to address seven issues in our recommendations about FmHA programs and I will try to be as brief as possible.

Issue one: Currently FmHA regulations prohibit FmHA from subordinating the agency's junior real estate liens.

This is a major disincentive to a lender who wants to restructure a borrower's loan and obtain an FmHA guarantee.

We propose that the FmHA be allowed the flexibility to subordinate their position when it does not increase the risk to the Federal Government.

Issue two: Currently, FmHA regulations limit interest accrual to 90 days, once a decision has been made to liquidate that loan.

We understand that there is a proposal to extend that by 2 months to 150 days and we applaud and encourage that proposed change in the regulations.

Issue three: Perhaps the most important issue that we face relates to the funding levels in fiscal year 1991 for FmHA loan programs.

We are concerned that the proposed funding levels for both the direct and guaranteed programs will be inadequate. More specifically, the Farm Credit System encourages that the future funding of FmHA Farm Ownership guaranteed programs remain at least at their current levels, and that is at $850 million.

We believe the St. Paul district could utilize up to $120 million of the $150 million that is proposed for 1991.

Senator CONRAD. This is Farm Ownership loans?

Mr. BUEGLER. This is Farm Ownership loans, yes.

Senator CONRAD. You believe in your district alone, you can use $120 million of the $150 million that is proposed?

Mr. BUEGLER. In fiscal 1991, yes.

Senator CONRAD. Of the $120 million. Is that based on a survey of your offices? How did you arrive——

Mr. BUEGLER. This is based on an estimate of the loan restructures that we have maturing next year. That perhaps up to one-third of those would qualify for guarantees, and we have an excess of $300 million maturing and feel that we will need about $120 million or could utilize that amount for farm-ownership alone.

Senator BOSCHWITZ. Those are guarantees?

Mr. **Buegler.** Guarantees, yes. We also believe now is not the time for a cutback in direct lending programs and you heard from both these comments here and in the State of North Dakota last year, so primarily it relates to that State. There are very serious problems up there and what might develop in 1990 cropping season.

Our fourth issue is that the 90 percent guarantee level should not be reduced.

In order to maintain incentives for lenders to continue to use existing programs, we urge Congress not to reduce the current maximum guarantee level of 90 percent.

Issue five: FmHA does not allow flexibility in setting the interest rate on guaranteed loans.

We suggest that lenders would be given flexibility in pricing guaranteed loans to allow a lender to cover direct servicing costs incurred.

Issue six: Another primary concern is that institutions of the Farm Credit System should be permitted to make community development loans, as well as participate in the proposed community development guaranteed loan program, if they are enacted.

New authority is contained in rural development legislation pending in both the House and the Senate. It would permit the System to better serve rural communities and allow for much needed diversification in our portfolio. We also recommend passage of that provision.

Issue seven: Expand guarantee programs to include leases.

At the present, FmHA loan guarantee programs do not provide for the guarantee of equipment leases and we encourage Farmers Home to explore statutory and regulatory changes that would provide leasing guarantees as an additional source of financing.

I WOULD LIKE TO ADDRESS SENATOR BOSCHWITZ AND HIS QUESTION TO ME ON DUMPING

Before I conclude my remarks, I would like to address Senator Boschwitz and his question to me on dumping. I can only make an observation for what is occurring in the four States where we operate. In those four States, we write 70 percent of all the FmHA guarantees and have experienced in recent years only 30 percent of the losses. Banks, on the other hand, account for 30 percent of the guarantees and the FmHA is experiencing 70 percent of the losses on their guarantees. So I hope that answers your question on dumping. Clearly the facts as it relates to Farm Credit in the four States that we operate do not warrant that comment in the written testimony of others.

CONCLUSION

In conclusion, the FmHA guaranteed loan program is working and the Farm Credit System has received good cooperation from the Farmers Home personnel. There are many sound reasons for the Farm Credit System to make even greater use of the Farmers Home guaranteed programs. Thank you for giving us the opportunity to state our commitment to making better use of these programs for our borrowers. And I would be pleased to answer any other questions that you may have.

[The prepared statement and chart of Mr. Buegler follow:]

THE FARM CREDIT COUNCIL
50 F STREET, NW · SUITE 900 · WASHINGTON, DC 20001 · 202/626-8710

Statement by

Larry Buegler, President & CEO
Farm Credit Bank of St. Paul

on behalf of
The Farm Credit Council

before the
Subcommittee on Agricultural Credit
Senate Committee on Agriculture, Nutrition & Forestry February

February 20, 1990

Mr. Chairman and Members of the Subcommittee.

My name is Larry Buegler. I am President and CEO of the Farm Credit Bank of St. Paul and CEO of the St. Paul Bank for Cooperatives.

I am testifying today on behalf of The Farm Credit Council, the national trade association which serves the Farm Credit System. This statement will speak to three issues on which you have asked the Farm Credit System to comment. They are:

- o views on existing FmHA guaranteed loan programs,
- o recommended changes to current programs to enhance program use, and
- o comments on the Administration's recommendations for revisions to FmHA programs and spending levels for Fiscal Year 1991.

Background

Farm Credit System institutions are cooperatively-owned by more than 600,000 farmers, ranchers and cooperatives who expect their associations and banks to provide competitively priced credit. As a cooperative, we are, therefore, keenly aware of their needs and particularly concerned about taking undue risks with the equity our borrowers have invested in their institution. Ultimately, we must be able to maintain good, high-quality service to current customers, assist those borrowers who experience financial difficulty, and seek new customers.

Prior to the Farm Credit System's financial difficulties, Farm Credit's use of FmHA guarantee programs was limited. If an individual met our loan standards, there was no need for a loan guarantee. But the economic environment changed, and we found that as the financial condition of a number of our borrowers declined, it became necessary to obtain guarantees on loans to reduce our credit risk, thereby permitting us to continue to finance these distressed borrowers.

I want to emphasize that we want to obtain guarantees on loans. This will work barring unforeseen, uncontrollable events. The Farm Credit System recognizes the need to use all available tools, including guarantee programs, to assist customers in restructuring loans. Currently, all System banks and all but a few associations qualify for FmHA's approved lending program. The System, as a whole, has increased use of these programs significantly in recent years and the trend is upward. Since 1986, there has been a 193 percent increase in System loan volume guaranteed by FmHA (see attached chart).

As you know, the St. Paul District has made extensive use of FmHA guarantee programs. Our district's FmHA guaranteed volume is over half of the System's total--some $334 million in guarantees on more than 3,000 farm ownership and operating loans. And in our district, our use is more than double the volume of guaranteed loans by commercial lenders in our four-state area.

Soon after I came on board in St. Paul, we made the business decision to aggressively restructure as much of our $1.1 billion in nonaccrual loans as possible. At the end of 1989, we had 8,500 restructured real estate loans totaling nearly $1.2 billion. As a result, our unrestructured nonaccruals are down to just over $100 million, less than 10 percent of what it was three years ago.

There is no question that the St. Paul District--bank and associations--has had good experience with FmHA programs. Much of our success can be attributed to working closely with state and national Farmers Home and USDA officials. We held numerous meetings to ensure that bank and association staff understood the mechanics and importance of these programs. We also invited county, state and national FmHA leaders to these meetings. In addition to gaining a better understanding of these programs, our dialogue resulted in a sharing of specific concerns about the guarantee programs which are not unique to our district.

Concerns & Suggestions about FmHA Programs

Mr. Chairman, we want to express our thanks for the hard work of FmHA county and state staff. Overall, we have found the FmHA staff to be a group of hard-working, sometimes overworked, dedicated people interested in making these programs successful.

I would like to address seven issues.

Issue 1:	Regulations prohibit FmHA from subordinating the agency's junior real estate liens.
Concern:	This is a major disincentive to a lender who wants to restructure a borrower's loan, and obtain an FmHA guarantee. To obtain a guarantee, FmHA requires the issuance of a new note which, in turn, causes Farm Credit to file a new mortgage in order to maintain its priority loan position. This, in essence, places the lender's restructured

loan in second position behind debt owed FmHA. As a result, this limits a lender's flexibility to effectively work with distressed borrowers.

Recommendation: We propose that FmHA be allowed the flexibility to subordinate their position when it does not increase the risk to the Federal Government. We understand that this issue is being examined within FmHA and may be in the process of being resolved, and we applaud these efforts.

Issue 2: Currently, FmHA regulations limit interest accrual to 90 days, once a decision is made that the loan must be liquidated.

Concern: Currently, Farmers Home regulations limit interest accrual to 90 days once a decision is made that the loan is to be liquidated. Typical liquidation periods are:

a) operating loans - six months without bankruptcy - one year with bankruptcy;

b) farm ownership loans - at least 1 1/2 years without bankruptcy 2 1/2 years with bankruptcy.

Recommendation: We understand that a proposal is under consideration within the agency to increase this interest accrual period by two months to 150 days. We applaud and encourage this proposed change to FmHA regulations, however we believe lenders should not be penalized by borrowers using litigation to lengthen the collection period beyond what FmHA permits interest accrual.

Issue 3: FY 91 funding levels for FmHA loan programs.

Concern: All FmHA programs are under close scrutiny by Congress, GAO and the Administration. We are concerned that the proposed funding levels for both the direct and guaranteed loan programs will be inadequate.

Recommendation: More specifically, the Farm Credit System encourages that future funding of FmHA Farm Ownership guarantee programs remain at least at current levels.

For example, the Guaranteed Farm Ownership Loans demand has far exceeded in each of the past three years the level of funding that the Administration is proposing for FY 91. To restrict funding, as proposed, would severely limit needed credit for financially stressed borrowers who would not be able to obtain credit elsewhere.

As our district indicated to you in your field hearing last week, we believe that St. Paul could utilize up to $120 million of the $150 million total proposed by the Administration in the 1991 budget request. In addition, St. Paul has $200 million in restructured loans that will mature in 1991.

Many borrowers have made significant strides in their financial recovery, but they remain in a very weak position. If we are to stay with these borrowers, we will need to obtain loan guarantees. We urge the Congress to maintain funding at no less than current levels for the guarantee programs.

We also believe that now is not the time for a cutback in the direct lending programs of Farmers Home. The current drought conditions in North Dakota and other states will have a direct impact on all lenders and farmers.

It is important that Farmers Home be there for farmers, including beginning farmers, who cannot access credit from either commercial or cooperative lenders. We recognize that the System can and should play a role in helping farmers to transition from these direct programs, and the guarantee programs help in that transition. Our view is that you cannot expect a large number of borrowers with direct loans to be able to transition to guaranteed loans without some interest rate subsidy to assist in that transition. Without an incentive for the farmer, this transition will not occur.

Issue 4: The 90 percent guarantee level should not be reduced and changes similar to other USDA guarantee programs should be considered.

Concern: Two other USDA guarantee programs have both higher guarantees and a different payment mechanism than FmHA programs. The GSM Export Credit Guarantee Program provides a 98 percent guarantee for the timely payment of both principal and interest. The Rural Electric Administration Guarantee Program provides a 100 percent guarantee on principal and interest. This contrasts with the FmHA programs which guarantee only a portion of a loss.

Recommendation: Changes to a GSM or REA-type guarantee would provide an additional incentive for lenders to use the FmHA guarantee programs, while advancing the agency's objective of shifting emphasis from direct to guaranteed lending programs. In order to maintain incentives for lenders to continue to use existing programs, we urge Congress to not reduce the current maximum guarantee level of 90 percent.

Issue 5: FmHA does not allow flexibility in setting the interest rate on guaranteed loans.

Concern: Currently, FmHA requires that the interest rate charged the borrower on a guaranteed loan be equal to the average rate charged to all borrowers. This is a sensitive issue to both borrower and lender. From the System's perspective, it is made even more difficult because of the significant pressure on Farm Credit institutions to return to profitability and to operate in a safe and sound manner as required by our regulator.

A 1988 American Bankers Association study revealed that it takes nearly three times the number of hours to complete an FmHA guarantee application and service a loan for a one-year period than it does for other farm loans. As you know, a guarantee reduces a lender's exposure to loss. It does not however, reduce the significantly higher servicing requirement. Most of the customers with guarantees would qualify for higher-than-average interest rates.

Recommendation: We suggest that lenders be given flexibility in pricing guaranteed loans to allow a lender to cover direct servicing costs incurred. Without this flexibility, borrowers that do not have a guarantee are forced to cover these costs or, needed guarantee credit could be severely restricted. Added flexibility for FmHA could result in the increased use of these programs and again meet FCA's requirements that the System recover its costs and operate profitably.

Issue 6: Institutions of the Farm Credit System should be permitted to make community development loans as well as participate in the proposed community development guaranteed loan program if enacted.

Concern: Currently, the authority for System institutions to make water and sewer loans is very limited. New authority is contained in rural development legislation pending in both the Senate and the House. It would permit the System to better serve rural communities and allow much needed portfolio diversification.

Recommendation: We recommend passage of this provision, and if the guarantee program for community development loans is enacted, that System institutions be declared eligible to participate.

Issue 7: Expand guarantee programs to include leases.

Concern: At present, FmHA loan guarantee programs do not provide for the guarantee of equipment leases. Such an expansion could provide a beginning or financially stressed farmer with access to needed capital with the result that the borrower's cash flow requirements would be substantially less than that required to finance the full purchase of the equipment.

Recommendation: We encourage FmHA to explore statutory and regulatory changes that would provide an additional source of financing for needed capital assets.

Conclusion

There are many sound reasons for the Farm Credit System to make greater use of the FmHA guaranteed loan programs. Among them, a guarantee:

- provides the borrower with time needed to return to a sound financial position;
- reduces lender risk to insure against uncontrollable factors;
- provides an opportunity to add new business by financing FmHA's current customers eligible to graduate from FmHA direct loan programs;
- provides a means to improve the credit quality of an institution's portfolio (under the Uniform Classification System, the guaranteed portion of the loan is classified acceptable);
- reduces capital requirements for guaranteed loans; and
- reduces premiums payable to the Farm Credit System Insurance Fund.

Several steps are being taken to increase the System's use of FmHA guarantees. There is a broad based effort within the System to educate both banks and associations about the value that guarantee programs offer to borrowers and to the System, primarily in the above ways. As a result of the action taken by Congress last November to reduce the premium payments to the Farm Credit system Insurance Fund for loans which are guaranteed, there should be heightened interest by System institutions in using the guarantee programs. We appreciate your efforts to get this legislation enacted. We realize, however, that the real impact will not be felt until this current program year.

Moreover, we believe that the process to significantly expand use of these programs may well take considerable time--time for developing close working relationships with FmHA county and state staff, time to work out processing procedures and gain a level of comfort that comes with use of the program. Most importantly, we are is directly related to the close ties which banks and associations establish with county Farmers Home staff.

At the System level, very close cooperation is being maintained with national USDA officials. We appreciate the commitment which Under Secretary Vautour and Deputy Under Secretary Kislak have made to working with the System. We believe that they are listening to our concerns and that they will make every effort to consider changes where they can.

Thank you for giving us the opportunity to state our commitment to making better use of the FmHA guarantee programs for our borrowers. I will be pleased to answer any questions that you might have.

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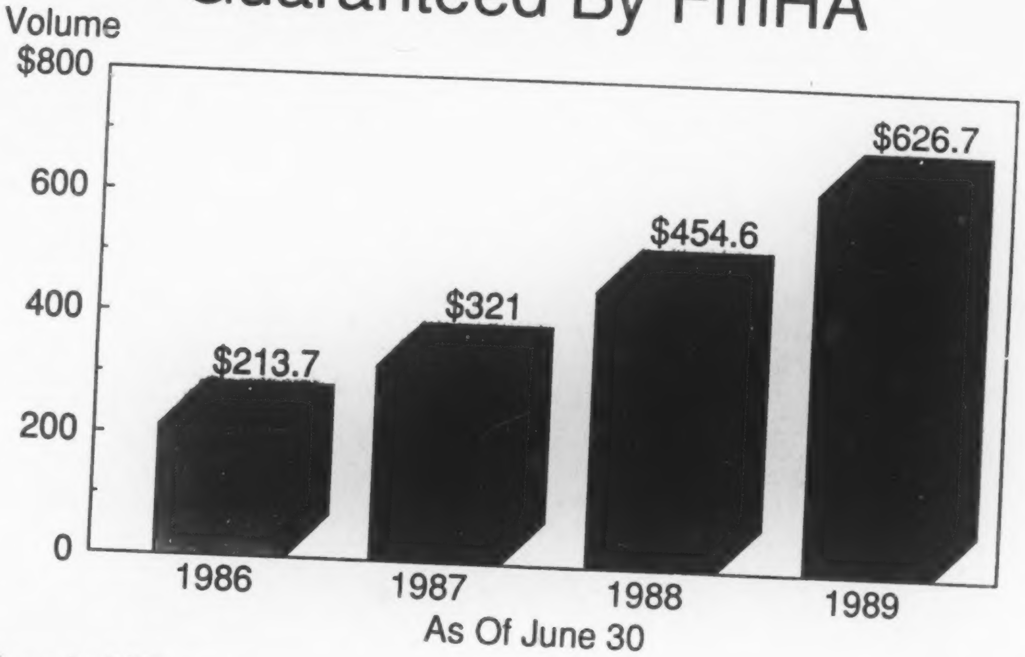
Total FCB Loan Volume Guaranteed By FmHA



(Values In Millions)

Texas Data Not Available
For 1986 and 1987

Senator **Conrad**. We do have a vote at 3:15 and I know Senator Boschwitz said he had some other things later. Senator Gorton.

Senator **Gorton**. I will defer.

Senator **Conrad**. I would be glad to do that as well, so that Senator Boschwitz will get a chance to get some questions in.

Senator **Boschwitz**. I may come back Mr. Chairman, because I would like to listen to the Acting Administrator and also to Ms. Roth. So why do we not go in the regular order.

Senator **Conrad**. All right. Let me say to the panel, I really got an earful in North Dakota. We had excellent witnesses, the head of the North Dakota Farm Bureau, head of the State FmHA, head of the bankers in the State, the State Agriculture Commissioner and others. And over and over, they sent a very clear and consistent message that we have an oversubscription for the direct loans, and an undersubscription for guaranteed loans in 1989. Only 35 percent of the authorized funding was used and they are asking why move toward even higher levels of guarantees and a sharp reduction in direct loans?

They also made two other points. One was that there does not seem to be a perfect fit between those who could get guarantees and those who get direct loans. And there is a concern that some banks have used the guaranteed program in order to move troubled loans off of their books. In fact, according to the GAO report [7] which some people cited, there is an indication that not many new borrowers are getting guaranteed loans; that they are mostly going to existing borrowers of private banks.

Please respond to that set of issues as to how you see it? Should we slow down the move to guaranteed loans? Mr. Grove.

Mr. **Grove**. Mr. Chairman, I can respond to at least part of that question. As I perceive the proposal, what they are proposing would be a step toward less direct lending, and I guess that is why we are saying that the direct lending program has to stay, but at a lower level. Presently the Federal Government has 100 percent of the risk, is doing all the work for management of the loans, as well as making below market rate interest rates. With the guaranteed proposal they would only have 90 percent of the risk to the Federal Government; the bankers would do at least a portion of the workup of the loans; and the interest rate would be somewhat subsidized by the Federal Government.

So I think there are some of the higher credit quality borrowers that are being direct now that would fit into the administration's proposal, but clearly not all of it. The other thing that is really important is that in the guaranteed program, they are looking for a minimum of 20 percent equity. I think what we are looking at is the higher quality of the direct portfolio presently. But there is clearly an awful lot of those that will not meet those standards.

Senator **Conrad**. Other comments? Gary.

Mr. **Nelson**. With the last five guaranteed loans that we have processed, they have been of the existing borrower who has reached that level of quality where he is nearly graduated or soon to be graduated in a few years. We have yet to experience "true beginning technical farmer guaranteed loan" but are more concerned here of that person out there that may not be part of the farmer or FmHA program that we feel that perhaps should be or could be.

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[7] Farmers Home Administration, Implications of the Shift From Direct to Guaranteed Farm Loans, GAO/RCED-89-86, GAO, September 1989.

Senator CONRAD. Larry, do you want to comment on this?

Mr. BUEGLER. Our assessment in the States where we operate is that up to 30 percent of the direct loan portfolio could graduate to a guarantee at some point in time. And for that reason, we have made a lot of effort to communicate with the FmHA field and our lending staff to work on that portfolio in the years to come to actually facilitate that graduating process, if the guarantees are available. And here again, if they are not available for farm ownership, then graduation will not happen.

Senator CONRAD. I heard a lot of comments that we need more money for Farm Ownership loans, both guaranteed and direct. Your testimony certainly supports that. Let me raise one other issue with you very quickly—the notion of the interest assistance program that has been proposed by FmHA. The hearing that we had in North Dakota indicated there was an interest in making that program an experiment. There was a lot of concern that 3 years of interest reduction is not enough; because people's equity buildup is so small in those first 3 years. They would be very vulnerable at the end of the 3-year period to an increased interest rate. I would be interested in your reaction to that.

Mr. BUEGLER. We made use of the buy-down program and like it, and it is of particular interest to us. And we are hopeful that it will be continued with the modifications that are being proposed. The two plus two and the one plus one and even the half plus a half is very beneficial to a lot of our borrowers.

Let me give you an example of how important it could be to us. Three years ago we restructured in a blitz process, over 2,300 farmers in our district in the first quarter of 1986, and those are maturing right now. Now these farmers by and large have had 3 fairly good years. Land values have increased, commodity prices have been up and moisture conditions have been fair. Of course, in North Dakota moisture has not been so good. But these folks are just getting back on their feet. Those restructures were written at an average of say 8 percent interest. With the thin equity that they have and if we have to move them to 12 percent, we have just set them back quite a ways and they may not be able to cash-flow.

With the increased land values, however, it may be cheaper for us to foreclose at this point rather than to restructure and that would be a shame if after we have come this far. We are looking forward to utilizing that interest rate buy-down program to get these folks through at least another 3 years. And the two plus two, for example, a farmer that is 8 percent would normally go to 12 percent. If we could keep that farmer in a two plus two, rather than 12 at an 8 percent by Farm Credit taking 2 percent absorption of interest and FmHA another 2 percent, it would be very helpful to us going forward.

Senator CONRAD. One of the points that was raised was just that we have a lot of people who are in this 3 year drought cycle. They are using that as an example of the difficulty we could create for ourselves by restricting it to 3 years. That is, we have a buy-down for the 3 years and we come to the end of the drought cycle that you are facing right now, then their interest rate would go back up while they are still at a very vulnerable stage because their equity is not increased very much. Your experience almost provides confirmation of the concern that they are surfacing.

Any other comment?

Mr. NELSON. I would concur with that. I question the time schedule. Three years definitely in a majority of the cases would not be enough time, particularly if there were any setbacks. It just would not be enough.

Senator CONRAD. One other question I would like to ask quickly before we go and vote is on the one-time write-down limitation that the Administration is proposing as part of the Agricultural Credit Act. The State Farmers Home Administration indicated these restructurings have been calibrated so closely in terms of cash-flow and payability that if we have a continuation of drought or we have some other down-turn, the one-time write-down limitation might just leave you with a whole group of folks that would get the axe. What is your reaction to that?

Larry, you have these people coming out of 3 years of drought. What is your reaction to the proposal of the one-time write-down?

Mr. BUEGLER. As I understand it the one-time write-down only applies to FmHA and not to Farm Credit.

Senator CONRAD. Right.

Mr. BUEGLER. Farm Credit is not part of that provision. That too causes us quite a bit of concern, especially after we have come this far and now will not have the tools available to restructure a restructure.

Senator CONRAD. Gary. Mr. Grove.

Mr. GROVE. That is a concern of ours. I think it needs to have more study into it.

Senator CONRAD. All right. We have a vote occurring. I think this would be an appropriate time to recess. Unless the two of you have completed your work here. You want to listen to the rest of the witnesses, do you not?

Mr. BUEGLER. I would like to listen to at least some of the additional witnesses, Mr. Chairman.

Senator CONRAD. We will take a brief recess and as soon as we can come back, we will go to further questioning of this panel and then we will go to the Acting Administrator and others.

[Recess.]

Senator BOSCHWITZ [presiding]. We are going to resume the questioning of Mr. Grove, Mr. Buegler and Mr. Nelson.

Mr. Nelson, I noticed in your testimony that you apparently did not like the interest buy-down as it required bank participation. I kind of find that an attractive element.

Mr. NELSON. No, Senator Boschwitz.

Senator BOSCHWITZ. Am I reading that wrong?

Mr. NELSON. Yes, you are. We have always appreciated and used the buy-down program as it was introduced and as it has been the last few years. This includes the bank that I am president of as well as the banks across the country. I think what I am talking about here is if they choose, that is, if the Farmers Home Administration or in fact the administration chooses to remove the sharing of the buy-down, and the FmHA accept the interest itself, we will probably encourage even more participation in that program.

Senator BOSCHWITZ. You employed the decision to terminate the requirement for bank participation in this program. From my standpoint I think that the mutual participation is one of the strong features of it. May I ask as a matter of interest, what are the footings of your bank?

Mr. NELSON. $40 million.

Senator BOSCHWITZ. And of yours, Mr. Grove?

Mr. GROVE. Mine is $20 million.

Senator BOSCHWITZ. That is a lot of money for those small communities. What percentage are you loaned out?

Mr. NELSON. For the most part in the spring, I suspect, Senator, we are in the area of 30 to 35 percent.

Senator BOSCHWITZ. Loaned out?

Mr. NELSON. Yes.

Senator BOSCHWITZ. And you, Mr. Grove?

Mr. GROVE. Our bank is 65 percent loaned out.

Senator BOSCHWITZ. I am flabbergasted that your bank is 35 percent period.

Mr. NELSON. Our bank is traditionally——

Senator BOSCHWITZ. Is 35 percent loaned out. What is it the rest of the time?

Mr. NELSON. It fluctuates between 28 and 35, Senator. Our bank, I might add, is a bank that many choose to save at rather than the alternatives which naturally raises our deposits much more than what you normally might think.

Senator BOSCHWITZ. I did not understand that.

Mr. NELSON. In addition to our lending function, Senator, our bank is chosen by the trade area as a savings institution, as we are blessed with the confidence of the people in our trade area that just choose to raise our deposits that high.

Senator BOSCHWITZ. Your loan to assets is about a third. Why should the Federal Government risk the taxpayers' money when you only risk a third of yours? Then you talk about people falling through the cracks. I am amazed that so little of your footings are loaned out.

Mr. NELSON. Senator and Mr. Chairman, we would be delighted to have more loan demand in our area. Of the two other banks in the county, one 28 miles southwest and the other one 28 to 30 miles southeast, have relatively the same ratios. And we are looking very aggressively to new loans and expand our opportunities, but mind you in doing that, Senator, we are admonished to adhere to the safety and soundness principles that the FDIC and the State banking requirements asked of us.

Senator CONRAD [presiding]. Maybe if I could just add a note. Two of the banks in our State that were heavy farm lenders and had what would still sound like very modest loan-asset ratios just failed. If you look at the economic conditions in North Dakota over the last 8 years with the collapse in commodity prices and the energy situation you would understand. Remember Stanley, North Dakota is out in the area that has not only suffered the collapse in commodity values in agriculture, but energy as well. The economic stress of that part of our State is acute, and coupled with these last

2 years of drought, we just had the dubious distinction of being named the largest outmigration State in the Nation by the Nation's moving companies.

Senator **Boschwitz**. Of the percentage or what?

Senator **Conrad**. Yes, the ratio between coming in and leaving.

Senator **Boschwitz**. Maybe the kind of representation they are getting up there. [Laughter.]

Senator **Conrad**. Actually I think——

Senator **Boschwitz**. They are moving into our State, I might add.

Senator **Conrad**. The local Republicans that represent that district will be, I think, chagrined to hear your comments.

Senator **Boschwitz**. How many people are in the county where you have your bank?

Mr. **Nelson**. I would say our trade area probably encompasses——

Senator **Boschwitz**. How many people are in the county?

Mr. **Nelson**. The county, I think, we have about 4,500 to 5,000.

Senator **Boschwitz**. And the trade area?

Mr. **Nelson**. The trade area, we would say 3,000 to 3,200 that are a trade area.

Senator **Boschwitz**. Mr. Chairman, big bank, $40 million in that little trade area and he says there are two more in the county. I have not made a study of it, but it sounds fairly lush to me. How many people are in your county, Mr. Grove?

Mr. **Grove**. 2,500.

Senator **Boschwitz**. Oh yes, you said that, 1,500 in your town. Are you the only bank in the county?

Mr. **Grove**. We are the only bank in the county.

Senator **Boschwitz**. So his county is twice as large and has three banks. Are the other banks your size too?

Mr. **Nelson**. No, the other bank is about $38 million, the one to the southwest; and the other bank is about $28 million to the southeast.

Senator **Boschwitz**. A lot of money in that county, Mr. Chairman.

Senator **Conrad**. It is energy, Mr. Boschwitz. This used to be good times. Now it is hard times.

Mr. **Grove**. Mr. Chairman, I might just say that I think that is one of the reasons that we are saying that the B&I program be retained and what is happening in North Dakota is certainly indicative of our State in some ways too—maybe not our community, but other communities. What we are saying is not only a problem in the farm community, but it is the little town. It is the elevator that is not there any more. There is no longer a machine and equipment dealer. With the advent of more and more shopping centers in Bismarck or Great Falls, it is harder to have little retail stores as well.

What we are hearing is that in a lot of States, maybe not ours but in some others, that the Small Business Administration program is not very effective in little communities, in rural areas. And I think that the B&I program needs to stay alive for those places that are not serviced or at least the SBA needs to be instructed to do more in those communities if that is the case.

And this same rate buy-down that would also be available to farmers, be available to businesses in small communities. And I mean little communities, 2,500 or so, so that is the only place that they could get a 5 percent interest rate differential is in small rural communities. I think we would see business people move back into those communities. And if they had jobs and were working in those communities, maybe they would not need the interest rate down in their house loan.

I think there are some real opportunities with this concept that the administration has put forth. I just think we need to be looking forward to being aware that the direct program has got to stay in place. What we are really talking about here with this guaranteed farm program is probably the higher tier of the existing direct borrowers. But it is a very important step to see if this works. Because, if we streamline the guaranteed program, we throw in the interest rate buy-down into there and we communicate that with the various different lenders so that it streamlines the System.

I think we will see some banks making loans which will improve their loan-deposit ratio. Certainly they will make these loans if it is prudent and profitable.

Senator BOSCHWITZ. Do you think the Federal Government should perhaps ease some of its restrictions in judging the loans that you make in these communities so that we do not classify loans so rapidly? Do you have many classified loans in either one of your banks?

Mr. NELSON. You are talking about the regulatory Government now? [8]

Senator BOSCHWITZ. Yes.

Mr. NELSON. No, I think they are doing a pretty good job. In light of what is happening throughout the country, it is natural for them to be a little tougher now than they were a number of years ago. Not necessarily all the blame on the banking industry, but no, I cannot say. I think if there is one correction, Senator and Mr. Chairman, there would be to ask examiners or to expect examiners to be familiar with the trade area in which they are examining in. Because if you were to get an examiner that would not understand agriculture or would not understand the values of farm machinery, that might lend to some misunderstandings and some unfortunate classifications.

Senator CONRAD. Senator Gorton.

Senator GORTON. Thank you, Mr. Chairman. Each one of you has testified as to changes that you would like to make in the present System and some changes in direction you would like to make in the President's budget. I wonder if each of you could outline to me what you think the fiscal or money consequences of adopting your own proposals would be.

You, for example, Mr. Buegler, would like a larger loan guarantee availability. There would obviously be a Treasury cost in that. Those of you who prefer continuation or an expansion of the present direct loan system is obviously a cost in that. As we work on a farm bill, what is your best estimate as to the additional costs over and above what the President has asked for in his budget and his farm bill would attend the acceptance of your recommendations? Sure just go down the table.

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[8] Mr. Nelson noted in his returned transcript that he misunderstood Senator Boschwitz' question.

Mr. **Buegler**. Senator, the portion of this testimony that I was making as to the guarantee program has to do with Farm Ownership guarantees which this year is $800 million plus. The suggestion for fiscal 1991 is to reduce that to $150 million. All I am suggesting is that we leave it the way it is.

Senator **Gorton**. But that is the total amount of guarantees. How much will those guarantees cost us because of either subsidies for them or because some of them eventually be defaulted?

Mr. **Buegler**. The loans which I am suggesting we need those guarantees for are restructured loans in our portfolio that 3 years ago were our worst loans which have gone through a very difficult period. Today, 95 percent of those loans are current in their payment of interest and principal, and only 5 percent of them are delinquent. I believe it is the experience of the FmHA in recent years, at least in the area that we operate that losses on those guarantees have been negligible. So in terms in cost, it is no where near the $800 million. It is only a fraction of those loans where the Government would have to come forward and honor a guarantee.

Senator **Gorton**. So you are saying we could follow your recommendations practically free?

Mr. **Buegler**. What you are really guaranteeing us against is uncertainty. If it rains in our area, if interest rates do not spike upward, the chances of being called on those guarantees is remote. What you are guaranteeing us against are the uncontrollable events that would impact farmers with a very low amount of equity in their farming operation today. And that is what we are looking for guarantees on is those, or uncontrollable events, that would cause us losses.

Senator **Gorton**. Mr. Grove.

Mr. **Grove**. Senator Gorton, basically we are supporting the shift that the Administration has put forth. Also, the use of the interest rate buy-down they are proposing. The only thing different that we addressed in our testimony has to do with the retention of the B&I program which they are suggesting to eliminate. We think it is critical to the survival of the small town. I believe the level of funding last year was at $95 million.

Senator **Gorton**. And that would be sufficient in your view?

Mr. **Grove**. Assuming that it did stay in and it was at that level, which has been proven to be used up very quickly, so it could be expanded even more. But assuming that all of that $95 million received the interest rate buy down, as we were suggesting for these small communities, it would have a tremendous impact in rural America. That would be 5 percent of that $95 million.

Senator **Gorton**. Mr. Nelson, you probably disagree more with the proposed system than any of the other two did. What would you estimate the cost of going your way?

Mr. **Nelson**. I do not have any accurate figures, Senator, but let me add that I believe, Senator and Mr. Chairman, that with the expansion of the guarantee program and with the commercial banker together with the Farm Home working with the borrower that the cost to the Government should inevitably be less. My opening remarks, admonishing not to completely eliminate the direct program, were not so much for the farmer who has lost because of a loss of financial resources through poor management, but more to sustain that farmer who has already proven himself who might have fallen through the cracks because of some unforeseen circumstances.

Let me add one more thing, Senator and Mr. Chairman, and that is the conceptual approach. Is it going to cost the same? Should it be less or should it be more? The concept is will Farmers Home, FmHA, going to be the lender of last result? And has there been a determination of what is going to be the population of our agriculture community, that body of people that have sustained themselves now almost a century and a quarter in the Midwest. What is going to be the number of farms, the number of farmers that have for so many years provided this country with the staples at the lowest price in the world?

I know one way in which we could probably spend more money in a price support system and less money maybe in other areas if we could possibly structure the whole budget in an orderly fashion. I do not know if I have a clean answer to that.

Senator GORTON. No, I think that was a most eloquent answer. But I assume the answer is that that farm population would be measurably higher and more secure if we follow your recommendations than if we followed those in the President's outline farm bill?

Mr. NELSON. Senator and Mr. Chairman, I base most of what I said on the dollars received from the commodity prices as compared from the dollars of input. It is pretty tight as it is right now.

Senator CONRAD. There are two other points that I think we probably need to make. The first is a very simple matter of what are people seeking and what are they getting? The direct loans are oversubscribed. In 1989, the last year we have a full year of data, only 35 percent of the authorization for guaranteed loans was used. That should send us some kind of a message as to what is happening.

The second thing I think we need to find out is what the GAO report [9] asserts. It tells us that the losses in the guarantee program are going up sharply. Because of the strange way the Federal budget system works and the way we score these things on the budget, a direct loan counts as an outlay when you make it. A guaranteed loan does not count against the budget until the guarantee becomes delinquent and a loss claim is paid. But we will have a chance to talk about this when we get to our next panel.

I want to thank this panel very much for your participation today. Next we will go to Neal Sox Johnson, the Acting Administrator of Farmers Home Administration; John Harman, the Director of the General Accounting Office, Resources, Community and Economic Development Division; and Randi Roth, attorney at law for the Farmers' Legal Action Group.

I want to welcome this panel of witnesses. Sox, why do we not proceed with your testimony? We will get the testimony of all the witnesses in this panel and then we will open it up for questions. Welcome and proceed.

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[9] Farmers Home Administration, Implications of the Shift From Direct to Guaranteed Farm Loans, GAO/RCED-89-86, GAO, September 1989.

STATEMENT OF NEAL SOX JOHNSON, ACTING ADMINISTRATOR, FARMERS HOME ADMINISTRATION, U.S. DEPARTMENT OF AGRICULTURE, WASHINGTON, DC; ACCOMPANIED BY GLENN J. HERTZLER, JR., PROGRAM OPERATIONS, ASSISTANT ADMINISTRATOR FOR FARMER PROGRAMS

INTRODUCTION

Mr. JOHNSON. Thank you, Mr. Chairman and members of the committee. I do appreciate the opportunity to report to you today on our transition from direct to guaranteed farm loans, as mandated by the Food Security Act of 1985. Our experience in guarantees has increased substantially over the past few years. Today, I can say that guaranteed loans are an established and accepted element in our loan portfolio.

GUARANTEED LOANS

A decade ago, guaranteed loans constituted only a fraction of our overall farm lending. In fiscal year 1982, for example, guaranteed loans amounted to $51 million out of our total farm lending of more than $4 billion.

As a result of the energetic efforts by the administration, guarantees increased to $1.2 billion—20 percent of the total—by fiscal year 1985.

That year, Congress endorsed the concept of FmHA guaranteed loans in the Food Security Act of 1985. In a 3-year authorization of funding for operating and ownership loans, the act began the transition at one-half direct and one-half guaranteed in fiscal year 1986, with the third-year ratio set at one-fourth direct and three-fourths guaranteed for fiscal year 1988.

On a dollar basis, the 1985 act increased the guaranteed authorization by $500 million each year.

INTEREST WRITE-DOWN PROVISION

Two other factors helped boost activity in guarantees. One was the interest write-down provision of the 1985 act, designed to help farmers who were undergoing economic stress.

Under that provision, FmHA could match—by up to 2 percentage points—a reduction in the interest rate by a commercial or cooperative lender if that would result in a sound cash-flow position for the borrower. In other words, the borrower could have an interest rate reduction of up to 4 percentage points and the lender would have an FmHA guarantee reducing the risk on a sounder loan.

Interest write-down was authorized for 3 years in the 1985 act, and it was extended for another 3 years in the Agricultural Credit Act of 1987. Obviously, that is the one that expires in 1991 as you have been referring to earlier today.

During a 4-year period, from fiscal year 1986 through 1989, interest was reduced on 7,700 loans totaling $888 million. FmHA paid the lenders $52 million in interest assistance through write-downs.

OPERATION ASSIST

The other factor helping the rise in guarantees was Operation Assist, which is an FmHA innovation designed to obtain credit in situations when the FmHA county office found that a direct loan borrower would qualify for the loan with a guarantee.

Under Operation Assist, county office personnel would escort the farmer-applicant to the bank or the other lender, with paperwork already prepared and in hand, to seek a guaranteed loan.

In the 3 fiscal years ending with 1988, 4,765 farmers obtained guaranteed loans totaling more than $362 million under Operation Assist. Those were loans that quite likely would not have been made otherwise.

That success with Operation Assist also allowed us to give more supervision to those direct loan borrowers who had not achieved a level of success and acceptance required by commercial lenders.

With this impetus, guarantees grew each year, reaching $1.6 billion in fiscal year 1986 and again in 1987, when they accounted for 51 percent of all farmer program loans. Guarantees have accounted for more than 50 percent each year since.

THE GUARANTEED PROGRAM HAS MADE IT POSSIBLE FOR MANY FARMERS TO STAY WITH THEIR LENDERS DURING THIS ECONOMIC ADJUSTMENT

The guaranteed program has made it possible for many farmers to stay with their lenders during this economic adjustment, and they are now in a position to move ahead.

As a matter of interest, Mr. Chairman, the States with the highest volume of guaranteed farm loans in fiscal year 1989 were Louisiana, Texas, Iowa, Illinois, Wisconsin, Minnesota, Nebraska, Michigan, Arkansas, Mississippi, Oklahoma, North Dakota and Kansas—in the heart of the Farm Belt.

THE PERFORMANCE OF THOSE LOANS HAS MET EXPECTATIONS

The performance of those loans has met expectations. Our current portfolio of $3.65 billion in guaranteed Farm Ownership and Operating Loans shows 1.2 percent delinquent which is a drop from 1988. On the direct loan side, 16 percent is delinquent of the $13 billion in Farm Ownership and Operating Loans in the overall portfolio.

This difference is shown in another way. For fiscal year 1989, write-offs and other cumulative losses in the direct lending program totaled $3.2 billion. This does not include interest assistance. For the guaranteed portfolio, the comparable figure was $68 million.

The guaranteed portfolio is more recent and does not include long-standing delinquencies that account for most of the losses on the direct loans. We think, however, that the guaranteed portfolio will remain relatively loss-free as it matures because commercial standards were used in making those loans, and serious delinquencies have been avoided to date.

AS A RESULT OF OUR EXPERIENCE, WE BELIEVE GUARANTEES ARE THE DIRECTION WE SHOULD CONTINUE TO FOLLOW

As a result of our experience, we believe guarantees are the direction we should continue to follow—for even more reasons. Because the lender makes and services the loan, guaranteed lending frees our people to concentrate their efforts on supervised credit with direct loan borrowers and to work more closely with beginning and socially disadvantaged farmers, as well as take care of other rural development activities.

We also should recognize the benefits to the farm community, in fact the entire rural community, of maintaining a viable, sound commercial lending structure in rural areas.

WE ARE PROPOSING A UNILATERAL INTEREST ASSISTANCE PROGRAM

We are planning a new step to increase the availability of loan guarantees to borrowers who otherwise could not qualify for them. As we discussed previously with you and the committee, Mr. Chairman, we are proposing a unilateral interest assistance program—for which we already have statutory authority.

Under this plan, we would—based on the cash-flow needs of the borrower—give interest assistance up to a maximum of 4 percentage points, for an average of 3 percentage points, for new guarantees. This would allow borrowers whose financial strength is not quite up to the lenders' regular standards to qualify with this assistance.

Also I might add here, that this would not have a 3-year deadline on it, as with the previous program that we had under the 1985 Ag Credit Act which gave us that 3-year debt write-down type. This would be for the life of that loan.

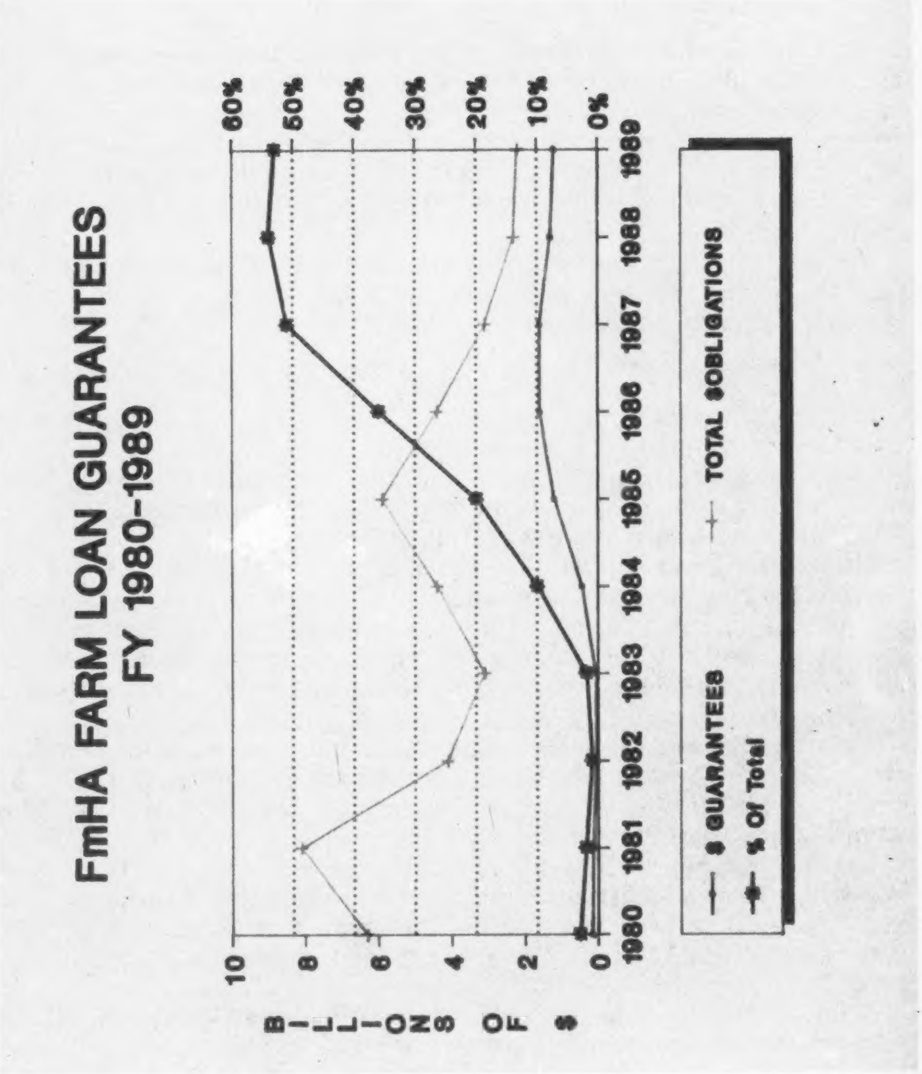
Let me emphasize that all of our borrowers will still be served. We will retain a sufficient safety net to take care of those borrowers whose credit will not qualify them for a guarantee even with the interest assistance. We are not abandoning anyone in this program.

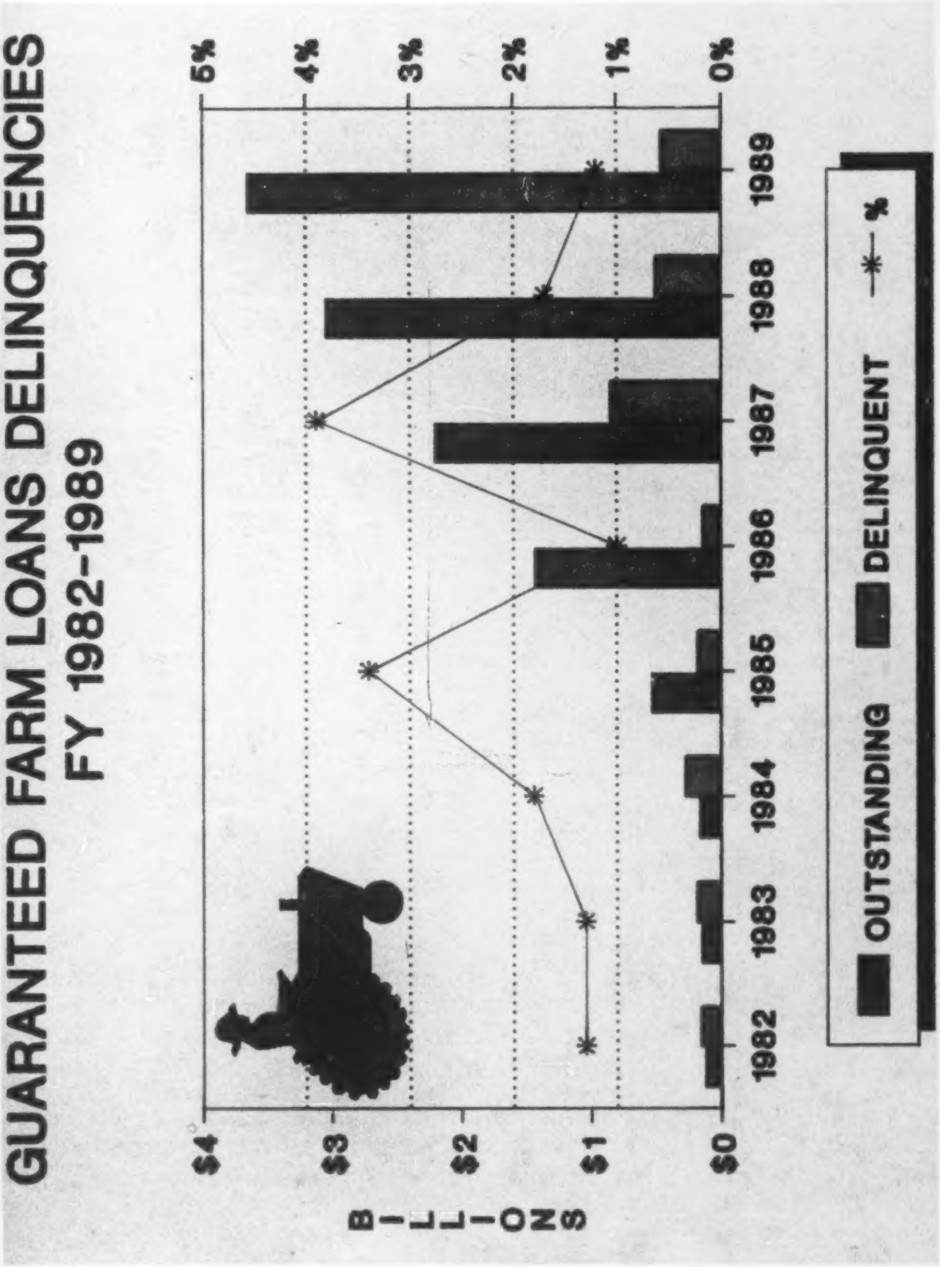
Another step to improving the guaranteed loan program will be to work more closely with private sector lenders in training our people and in developing common forms and procedures. We have achieved some success along these lines, and we believe that more is possible. We intend to work to that end in encouraging greater participation by lenders and in striving to increase the quality of our credit overall.

I am submitting for the record some statistical material that illustrates the development of our guarantee program in recent years.

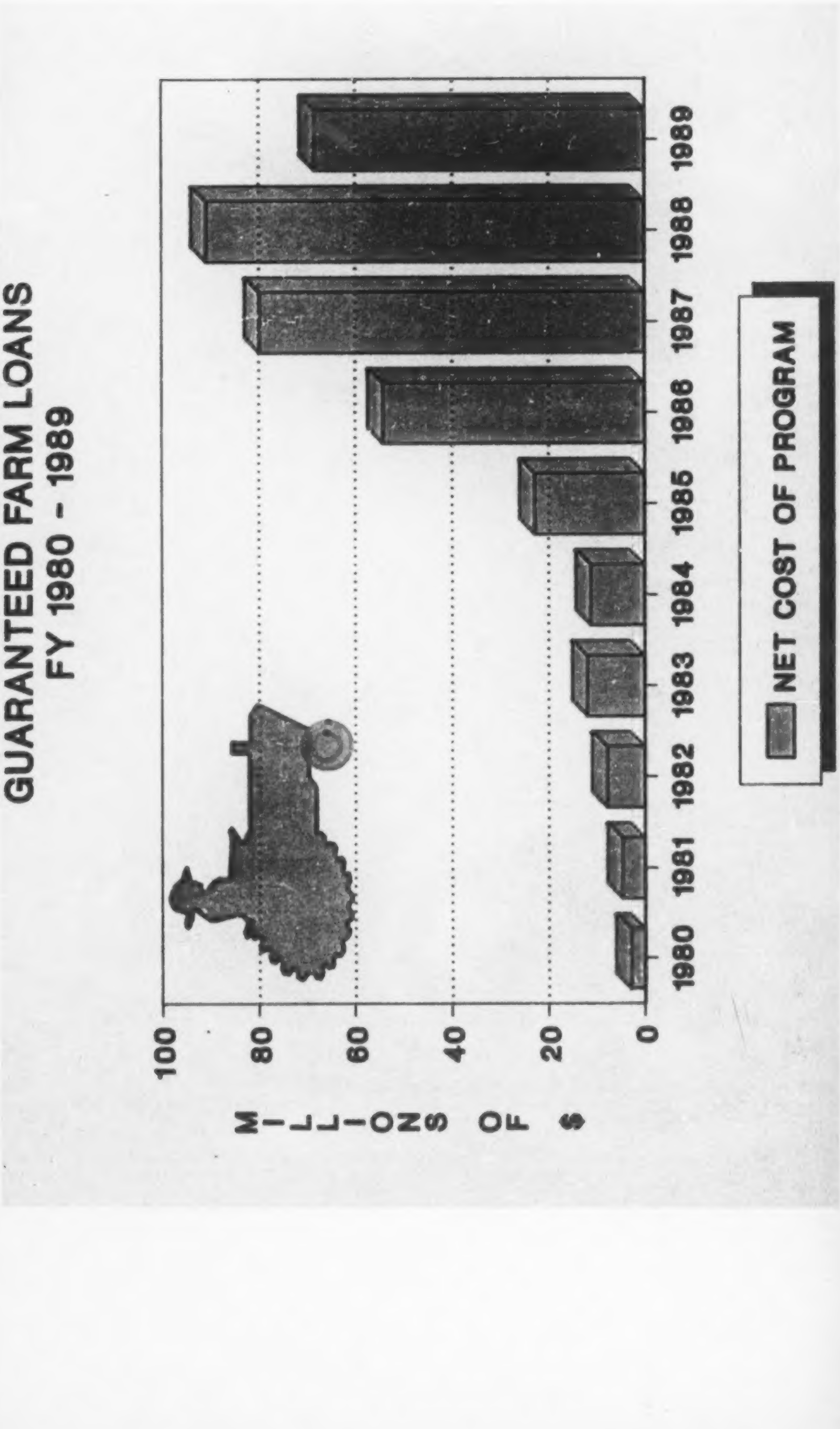
This does complete my formal statement, Mr. Chairman. I will be happy to answer any questions that you might have, and I ask you to please bear with me, as my sinuses are really working me over this afternoon.

[The statistical material submitted by Mr. Johnson follows:]


FmHA FARM LOAN GUARANTEES
FY 1980-1989
BILLIONS OF $
10
8
6
4
2
0
60%
50%
40%
30%
20%
10%
0%
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
$ GUARANTEES
% Of Total
TOTAL $OBLIGATIONS



GUARANTEED FARM LOANS DELINQUENCIES
FY 1982-1989


GUARANTEED FARM LOANS
FY 1980 - 1989
MILLIONS OF $
100
80
60
40
20
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
NET COST OF PROGRAM

Senator CONRAD. All right. Mr. Harman, do you want to proceed with your testimony?

STATEMENT OF JOHN W. HARMAN, DIRECTOR, FOOD AND AGRICULTURE ISSUES, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON DC; ACCOMPANIED BY JOHN HUNT, ASSISTANT DIRECTOR, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, GENERAL ACCOUNTING OFFICE, AND HAROLD DIGHTON, GAO EVALUATOR

Mr. HARMAN. Thank you, Mr. Chairman and the members of the subcommittee.

INTRODUCTION

Before I begin I would like to introduce several people who have been key in carrying out our work in the Farmers Home area over the last 5 years. Near your right is John Hunt who is responsible for all of our work in the farm credit area. On my far right is Harold Dighton who, over the last several years, has been carrying out our work on this particular program we are talking about today, the guaranteed loan program.

We are pleased to be here this afternoon to discuss that program. Unlike our previous testimonies over the past several weeks relating to the role and mission of Farmers Home, my testimony today focuses on our recent work relating to the loan guarantee program, as well as the implications of the increasing shift from the direct loan program to the guaranteed program.

WE ARE SOMEWHAT DOUBTFUL ABOUT THE PROSPECT THAT EXISTING DIRECT LOAN BORROWERS WOULD BE ABLE OR EVEN WANT TO OBTAIN GUARANTEED LOANS

In summary, and I will be summarizing my prepared statement which has been submitted for the record, we are somewhat doubtful about the prospect that existing direct loan borrowers would be able or even want to obtain guaranteed loans. As a result, continued direct funding will likely be required despite the administration's fiscal year 1991 request for reduced funding.

Also increased government exposure to direct and guaranteed loans and increasing guaranteed loan losses, some as a result of management weaknesses, could impact the budget outlays. In this regard, there are several key points I would like to highlight from our work, and I would emphasize here these are raised more in the context of being red flags that we think are concerns that the subcommittee may want to deal with in considering this shift. It is not a criticism. We are not criticizing the direction that Farmers Home is going in and moving in, but we think there are things that have to be dealt with.

ISSUES THAT HAVE TO BE DEALT WITH

First, rather than the direct borrower shifting to guaranteed loans, most direct loans are being made to commercial lenders' existing borrowers who are experiencing financial stress.

Senator CONRAD. Direct loans or guaranteed loans?

Mr. **Harman**. Guaranteed loans. I will be talking about guaranteed loans totally. So most of these loans are being made to the commercial lenders' existing customers. Only 2 percent of the direct loan borrowers obtained guaranteed loans of a similar type during the period 1985 to 1987. The Inspector General also did some work in this area and found, looking at some 16,000 borrowers as a sample, a 1 percent rate.

Senator **Boschwitz**. I did not understand that. One percent of what?

Mr. **Harman**. One percent in terms of the OIG. They looked at 16,000 direct loan borrowers and found that 1 percent of them had qualified for guaranteed loans. So the point is that not very many direct loan borrowers are shifting over to guaranteed loans. Most of these loans are being given to existing customers or existing borrowers in the commercial sector.

A February 8, 1990 report which was issued just several weeks ago on the use of loan funds in 1988 shows that private lenders' existing borrowers receive 79 percent of the guaranteed loan funds that were made; 69 percent of ownership funds; and 34 percent of operating funds were used to refinance existing debt.

Both Farmers Home and non-Farmers Home lending officials told us that the direct borrowers are not shifting to guaranteed loans largely because they are in such poor financial condition that lenders are not willing to extend credit even with a guarantee. Also, there is little incentive for direct borrowers to seek guaranteed loans because the higher interest rates on guaranteed loans and the 1 percent origination fee. Yet the demand for direct loans has been pointed out here several times this afternoon has been strong, while the demand for guaranteed loans has been less than authorized.

We believe the recent initiatives to keep direct borrowers in business will keep demand for direct loans high. Thus decreases in direct loan funding as proposed in the fiscal year 1991 budget may restrict credit availability to current direct loan borrowers. The guaranteed loan program is also facing the prospect of increasing losses. The allowance for loan losses at the end of fiscal year 1988 was $1.2 billion out of an outstanding principal of $3.6 billion.

At the same time the government's financial exposure has risen by $570 million through 1988 because the increase in guaranteed loans has outpaced the decrease in direct loans.

Senator **Boschwitz**. Did you say $1¼ billion of guaranteed loans was lost from——

Mr. **Harman**. No. The allowance for loan losses has been set at about $1.2 billion out of a $3.6 billion outstanding principal.

Senator **Boschwitz**. That is a charge on the budget?

Mr. **Harman**. No, that is not a charge on the budget. It is not charged to the budget until you actually incur the loss. This is an account that is set up within the financial statements to allow for loan losses that have been determined that could occur or would occur in the future. Farmers Home goes through a process to identify those high risk loans or those loans which they think will incur losses. And at this point it has been set at $1.2 billion.

Our work as well as the work of the Inspector General has found that Farmers Home contributed to loan losses because of inadequate assessment of borrowers financial conditions before loan approval and insufficient oversight of lender servicing of guaranteed loans after approval. This situation is similar to what we have seen over the years in the direct loan program which, as you know, has incurred substantial losses.

It is important for these management weaknesses to be corrected as guaranteed loans increase to avoid future losses and budget outlays. We have made several recommendations for such improvements.

THE ADMINISTRATION'S PROPOSED INTEREST SUBSIDY PROGRAM

My last point, Mr. Chairman, concerns the Administration's proposed interest subsidy program which has also been referred to several times this afternoon. This is intended to be an incentive for lenders to make guaranteed loans, particularly to existing direct loan borrowers. Although this program is more generous than the current interest rate reduction program, experience with that program raises some doubts as to whether such a subsidy will provide sufficient incentive to commercial lenders to make guaranteed loans to direct borrowers. Less than 13 percent of the funds authorized for the interest rate reduction program were obligated from 1986 through 1989.

CONCLUSION

Our discussions with a number of lending institutions has shown there are two primary reasons non-FmHA lenders do not use the current program. First, and we think foremost, is the high risk of financial failure of these borrowers because of their marginal financial condition. The second reason is the paperwork involved.

We believe it is extremely important for the Congress to examine this proposal and the others mentioned today closely to evaluate the likelihood that the commercial lending community will support such proposals. That completes my summary, Mr. Chairman.

[The prepared statement and attached appendixes I-II of Mr. Harman follow:]

United States General Accounting Office

GAO

Testimony

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The Farmers Home Administration's Guaranteed Farm Loan Program

Statement of
John W. Harman, Director
Food and Agriculture Issues
Resources, Community, and Economic
Development Division

Before the
Subcommittee on Agricultural Credit
Senate Committee on Agriculture,
Nutrition, and Forestry

GAO/T-RCED-90-31

GAO Form 160 (12/87)

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our work on the Farmers Home Administration's (FmHA) guaranteed farm loan program.[1] In our past work and previous testimonies on FmHA farm loan programs, we broadly assessed the problems facing FmHA. Today, we would like to highlight our concerns about FmHA's guaranteed farm loan program and the implications of the shift from direct to guaranteed farm loans.

In summary, our work on FmHA's guaranteed farm loan program showed that even though guaranteed farm loans have increased, most loans are being made to commercial lenders' existing customers who had become financially stressed. Few direct loan borrowers have obtained guaranteed loans with private lenders, or are likely to, because their poor financial conditions make private lenders reluctant to finance them even with loan guarantees. As a result, continued direct loan financing--despite the administration's fiscal year 1991 budget request to severely reduce such financing--will likely be required if existing direct borrowers are to stay in business.

Guaranteed loan losses are increasing at a faster rate since 1984 than has the amount of guaranteed loans. Also, the increase in outstanding principal for guaranteed loans has outpaced the decrease in that for direct loans. Consequently, the government's overall financial exposure has increased.

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[1] We have issued three reports focusing on various aspects of FmHA's guaranteed farm loan program: (1) Farmers Home Administration: Status of Participation in the Interest Rate Reduction Program (GAO/RCED-89-126BR; June 15, 1989), (2) Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86; Sept. 11, 1989), and (3) Farmers Home Administration: Use of Loan Funds by Farmer Program Borrowers (GAO/RCED-90-95BR; Feb. 8, 1990).

FmHA has contributed to guaranteed loan losses by inadequately assessing borrowers' financial conditions before approving guaranteed loans and by insufficiently overseeing lenders' servicing of loan guarantees after approval. As guaranteed loan losses increase, so will budget outlays. Thus, correcting the problems causing the increasing losses grows in importance. In our September 1989 report, we made several recommendations to help control losses and improve management of FmHA's guaranteed farm loan program.

FmHA's GUARANTEED FARM LOAN PROGRAM

Until the early 1970s FmHA, an agency of the U.S. Department of Agriculture (USDA), provided credit directly to farmers through government-funded (direct) loans. Then, in 1972 the Rural Development Act authorized FmHA to guarantee farm loans made by private lenders. By design, the guaranteed loan program makes credit available to family farm owners or operators who are unable to qualify for adequate credit from commercial agricultural lenders without a loan guarantee. The financial conditions of these borrowers are normally slightly better than would qualify them for FmHA's direct loans. Eligibility criteria for direct loans stipulate that borrowers must not be able to obtain private financing at reasonable rates and terms. In guaranteeing farm loans, FmHA agrees to reimburse the private lender for up to 90 percent of lost principal, interest, and reasonable liquidation costs if the borrower defaults on the loan.

In fiscal year 1984, FmHA began emphasizing guaranteed farm operating and ownership loans to help keep lending in the private sector, reduce budget outlays, and better service a growing but deteriorating direct loan portfolio. The Food Security Act of 1985 and subsequent appropriations legislation supported FmHA's shift from direct to guaranteed farm loans. The Agricultural Credit Act of 1987 also emphasized the use of guaranteed loans by stating that the Secretary of Agriculture should issue guarantees to the maximum extent practicable to assist eligible borrowers whose loans are being restructured by lenders.

As a further incentive to promote guaranteed loans, FmHA was authorized by the Food Security Act of 1985 to implement an interest rate reduction (IRR) program for guaranteed farm loans through September 30, 1988, with funding not to exceed $490 million. The Agricultural Credit Act of 1987 extended the program through September 30, 1993. The IRR program helps private lenders provide credit to family farmers who are temporarily unable to project a positive cash flow on all income and expenses without a reduced interest rate. When lenders reduce interest rates, up to a maximum of 4 percentage points, they receive payments from FmHA in amounts equal to not more than 50 percent of the reduction. These payments cannot be provided past the outstanding term of the loan, or 3 years, whichever is less.

FmHA's two principal types of guaranteed farm loans are (1) farm operating loans for feed, seed, fertilizer, livestock, farm and home equipment, living expenses, and seasonal hired labor and (2) farm ownership loans for buying and improving farm land and constructing, repairing, and improving buildings. Both types of loans can be used to refinance existing debts.

FmHA's guaranteed loan requirements regarding borrower eligibility, loan purpose, loan repayment periods, and security are similar to those for direct loans. Guaranteed loans differ, however, in that (1) the interest rate private lenders charge is generally higher, (2) the loan limits are higher ($400,000 versus $200,000 for farm operating loans and $300,000 versus $200,000 for farm ownership loans), and (3) lenders are responsible for servicing the loans. Appendix I provides further information on guaranteed farm loans as of September 30, 1989.[2]

GUARANTEED LENDING HAS INCREASED, BUT FEW DIRECT BORROWERS OBTAINED GUARANTEED LOANS OR HAVE AN INCENTIVE TO SEEK GUARANTEED LOANS

Although FmHA's farm lending is shifting to guaranteed loans, the increase in guaranteed lending has resulted primarily from private lenders obtaining loan guarantees for their existing customers who had become financially stressed. Few FmHA direct loan borrowers have switched to guaranteed loans with private lenders, or are likely to, because their poor financial conditions make private lenders reluctant to finance them even with loan guarantees.

As we reported in September 1989, our analysis of FmHA loan data disclosed that of 107,232 borrowers with direct farm operating and/or direct farm ownership loans in 1985 through 1987, only 2,195 (about 2 percent) obtained a guaranteed loan of the same type during the same period. USDA's Office of Inspector General (OIG), in a September 1988 report,[3] presented similar results. According to the OIG, about 1 percent of the 15,585 guaranteed farm loans totaling $1.5 billion in its sample universe were used to finance FmHA direct loan borrowers.

The FmHA state and county and private lending officials we interviewed said private lenders are primarily obtaining loan guarantees to cover loans made to their financially stressed customers who have either marginal loan security, marginal cash flow, or poor debt-to-asset ratios and insufficient net worth. Some lenders also obtain guarantees to avoid having bank examiners classify the loans as substandard.

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[2] All fiscal year 1989 data used in this testimony is preliminary, unaudited, and subject to audit adjustment at a later date.

[3] Farmers Home Administration Management of Farmer Program Guaranteed Loans Needs Improvement (USDA/OIG Audit Report 04665-2-Te, Sept. 29, 1988).

The use of guaranteed loans for the existing customers of private lenders and for refinancing purposes was also described in our February 1990 report on the use of FmHA loan funds. We reported that the existing customers of private lenders received about 80 percent of the fiscal year 1988 guaranteed farm ownership loan funds and about 79 percent of the guaranteed farm operating loan funds. In addition, about 69 percent, or about $250 million, of the $363 million of fiscal year 1988 guaranteed farm ownership loan funds were used to refinance existing debts of those who borrowed from private lenders. Only 20 percent, or about $73 million, of these farm ownership loan funds were used to purchase farm property. Although most of the guaranteed farm operating loan funds were used for farm operating expenses, we reported that about 34 percent, or $299 million, was used to refinance existing debts of those who borrowed from private lenders.

FmHA direct loan borrowers are not obtaining loan-guarantees primarily because most are in worse financial condition than are private lender borrowers and cannot qualify for private lender credit. As shown in our September 1989 report, about 40 percent (15 out of 38) of the private lending officials we interviewed in 8 states said their institutions were not willing to extend credit to FmHA direct loan borrowers--even with an FmHA guarantee. Of the 23 lending institutions willing to provide credit to FmHA direct loan borrowers, 21 would require the borrowers to meet more stringent loan eligibility criteria than FmHA's direct loan criteria, which requires only that income be at least equal to expenses and security be adequate to ensure loan repayment. These private lending institutions require borrowers to have higher cash flow margins (income exceeding expenses), security valued at more than the loan amount, and lower debt-to-asset ratios.

Private lenders can, and normally do, charge higher interest rates for higher-risk borrowers and may restrict credit when borrowers' collateral values decline. Under FmHA regulations, however, lenders cannot charge guaranteed loan borrowers a higher interest rate than they charge their average farm customers, which can be several percentage points lower than the lenders would normally charge high-risk farm loan borrowers. Lenders also generally pass on to borrowers FmHA's 1 percent guaranteed loan origination fee as part of the loan amount. FmHA does not charge such a fee for direct loans.

The guaranteed portion of guaranteed loans can be sold in the secondary market, thus providing an additional source of loan funds to the lender. As a result, the lender may be able to finance more high-risk borrowers during periodic liquidity shortages when credit may otherwise need to be rationed to better-risk borrowers. Further, during periods of economic stress that may cause collateral values to decline, borrowers who can demonstrate repayment ability may obtain guaranteed loans from their private lenders because the guarantees support the collateral.

Although guaranteed loans enable borrowers to obtain credit from private lenders at interest rates lower than they would normally have to pay as high-risk borrowers, the interest rates on guaranteed loans can range from about 3 to 7 percent higher than FmHA direct loan interest rates. As shown in our September 1989 report, from a random sample of 67 borrowers selected from 14 FmHA county offices in 8 states, the median interest rate that private lenders charged on guaranteed operating loans was 11.9 percent. In contrast, during fiscal year 1987 the FmHA regular direct loan interest rates ranged from 7.5 to 9.25 percent; the direct loan limited resource interest rate, which is a government subsidized rate, ranged from 4.5 to 5.75 percent. In October 1989, FmHA's regular direct ownership loan interest rate was 8.75 percent and the limited resource rate was 5 percent.

FURTHER SHIFT TO GUARANTEED LENDING MAY RESTRICT CREDIT AVAILABLE TO DIRECT LOAN BORROWERS

Over the past several years, FmHA direct farm operating loan credit has generally been made available to large numbers of borrowers even when FmHA direct operating loan funding availability became a problem. At such times, the Secretary of Agriculture made additional funds available by transfering funds between loan programs. In addition, FmHA helped some direct loan borrowers obtain private operating credit by subordinating its security or lien position to private lenders on collateral backing direct loans to these borrowers. For example, in fiscal year 1988 FmHA helped about 23,400 borrowers obtain $769 million in operating credit from private lenders through subordinations. Current direct loan borrowers are not shifting to guaranteed loans and requests for direct loans may not decline as anticipated because of congressional actions in 1987 and 1988 which made more borrowers eligible for direct loans. Further shifts from direct to guaranteed farm operating loan funding--the fiscal year 1991 budget proposes a reduction from $932 million for direct operating loans in 1990 to $500 million in 1991--may restrict credit available for direct loan borrowers in future years.

In contrast to the availability of direct farm operating loan funding, FmHA direct farm ownership loan funding has not been adequate in some years to meet loan requests. One reason for this inadequacy is that FmHA has attempted to curtail its direct farm ownership lending to make more direct loan funds available for what it considered to be higher priority operating loans and to emphasize guaranteed ownership loans. However, as in the case of operating loan funds, the Secretary of Agriculture transferred additional funds to the farm ownership loan program in some years, and the Congress provided supplemental appropriations for farm ownership loans in fiscal years 1983 and 1984.

FmHA has also assisted some direct loan borrowers to obtain private farm ownership credit through subordinations. For example, in fiscal year 1988 FmHA helped about 3,400 borrowers obtain about $90 million in private farm ownership credit through subordinations. However, further shifts from direct to guaranteed farm ownership lending may restrict credit availability for borrowers requesting direct farm ownership loans in future years.

Two congressional initiatives to help keep FmHA borrowers in business further affect future credit availability for direct loan borrowers. Both these initiatives will make direct loan credit from declining direct loan funds available to borrowers who, without these initiatives, would not be eligible for direct loans. These actions force direct loan borrowers who are current on existing loans to compete for declining direct loan funds with delinquent borrowers who were previously ineligible for continued financing.

First, in 1987 the Congress reinstituted the "continuation policy" which allows delinquent borrowers to reschedule or defer outstanding indebtedness to FmHA and to obtain additional operating loans without proving their ability to repay prior loans. This policy had been in effect from February 1982 to November 1985. Second, the debt restructuring provisions of the Agricultural Credit Act of 1987 provide for substantial revisions in FmHA's loan-servicing policies including debt write-down. FmHA will be required to write down debt if it is less costly to the government than foreclosure on borrowers who cannot make scheduled loan payments.

USE OF INTEREST RATE REDUCTION PROGRAM HAS BEEN MUCH LESS THAN AUTHORIZED

Although IRR obligations--the amount FmHA expects to pay lenders for reducing interest rates on guaranteed farm loans--more than doubled between fiscal years 1986 and 1987, obligations have declined in both fiscal years 1988 and 1989. FmHA estimated obligations of $100 million for fiscal year 1989, but actual obligations were about $14.2 million. Of the $490 million authorized for the IRR program, FmHA obligated only about $62 million on 9,371 guaranteed farm loans from program implementation in February 1986 through the end of fiscal year 1989. Moreover, as we estimated in our February 1990 report on the use of loan funds, in fiscal year 1988 about 70 percent of the guaranteed farm operating loans with interest rate reductions were used for refinancing debts of those who borrowed from private lenders.

In June 1989, we reported that according to national, state, and county FmHA officials and representatives of the banking community, a wide variety of reasons explained why IRR program participation by private lenders had not been greater. The most frequently cited factors were (1) the high risk of financial failure of borrowers unable to project a positive cash flow without IRR assistance and (2) the paperwork required to obtain the IRR. Our June 1989 report and the OIG October 1987 report[4] also stated that program participation would have been much lower had FmHA county offices adhered to regulations in approving IRR requests. Our limited review of IRR recipients in two states, and the OIG's more extensive review in three states, found that over 50 percent of the recipients should have been declared ineligible because they failed to meet the IRR program cash-flow criteria.

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[4] Farmers Home Administration's Guaranteed Loan Interest Rate Reduction Program (USDA/OIG Audit Report 04666-1-At, Oct. 22, 1987).

FmHA amended its regulations in January 1989 to require that a borrower show a cash flow of 110 percent--borrower's income exceeds all anticipated cash outflows by at least 10 percent--to gain approval for a guaranteed farm loan without IRR. However, if a borrower shows a projected cash flow between 100 and 110 percent, then regulations allow for IRR to be used on guaranteed loans. Despite these changes, however, IRR obligations were about $1.8 million, or 11 percent, less in fiscal year 1989 than in fiscal year 1988, and about $8 million less than the peak of $22 million in fiscal year 1987.

GOVERNMENT'S FINANCIAL EXPOSURE HAS INCREASED

Current direct loan borrowers have not shifted to guaranteed loans and most likely will not because of their poor financial conditions. Therefore, substantial budgetary outlays will probably be needed to finance these borrowers for the foreseeable future--if the government continues to help them stay in business as intended by 1987 and 1988 congressional actions. In addition, as we reported in our September 1989 report, the increase in outstanding principal on guaranteed farm ownership and operating loans had outpaced a corresponding decrease in such direct loans by about $570 million between fiscal years 1986 and 1988. Consequently, the government's overall financial exposure has increased.

GUARANTEED LOANS SIGNIFICANTLY BENEFIT LENDERS

FmHA's guaranteed farm loan program provides significant benefits to lenders. Loan guarantees enable lenders to continue financing borrowers who are poor credit risks because the guarantees protect lenders against potential loan losses. Further, the guaranteed portion of loans can be sold in the secondary market, thereby improving a lender's liquidity, enabling a lender to make long-term loans, and increasing a lender's profitability by charging the holder loan-servicing fees on the sold portion of the loan. Variable interest rates may be charged on guaranteed loans, thus shifting the risk of sharp changes in the lender's cost of funds. For banking institutions, the guaranteed portion of the loan does not count against the lender's legal lending limit, which enables the lender to make more loans, and bank regulators generally do not classify an FmHA-guaranteed loan as a weak loan if the bank properly services the loan. Although the private lending officials we interviewed were concerned about confusing program regulations and the amount of time and paperwork necessary to obtain an FmHA farm loan guarantee, 52 percent of the officials responding said such problems had little or no effect on their willingness to request guarantees.

To obtain loan guarantees and the benefits of those guarantees, lenders must agree to meet certain responsibilities. Additional paperwork and loan-processing time may be required. FmHA's regulations must be followed from the initial application, to final approval of the guarantee, to servicing the loan after the guaranteed loan is made. FmHA must approve any changes in the terms of the original loan--such as rescheduling or changing interest rates--and the loan must be serviced properly. Negligence or failure to meet these responsibilities can result in a reduction of the amount guaranteed by FmHA in the event of a loss.

PROGRAM PROBLEMS CONTRIBUTE TO LOAN LOSSES

Since 1984, losses on guaranteed loans have grown at a faster rate than guaranteed loan activity. FmHA has established an allowance for guaranteed loan losses of about $1.2 billion of the $3.6 billion in outstanding guaranteed farm loan principal as of the end of fiscal year 1988. Although loan losses may be caused by such uncontrollable factors as adverse weather, losses can also be attributed to problems in FmHA's assessment of borrowers' financial conditions prior to loan guarantee approval and in FmHA's oversight of lenders' servicing of loan guarantees after approval. These problems are similar to those FmHA has with its direct farm loans. As the shift continues from direct to guaranteed farm loans, correcting the problems with the guaranteed loan program grows in importance to control the mounting losses, prevent the loss of the shifts' budgetary advantage, and avoid the experience with the direct loan program.

Problems in Assessing Borrowers' Financial Conditions Prior to Loan Guarantee Approval

Our September 1989 report, as well as the September 1988 OIG report, disclosed three basic problems that FmHA has in assessing borrowers' financial conditions prior to loan guarantee approval: (1) poor assessment of borrowers' repayment ability, (2) insufficient determination of collateral securing guaranteed loans, and (3) unclear guidance for determining the appropriate percentage of guarantee.

The primary problems regarding repayment ability were understatements and/or overstatements of expense and income amounts on the borrowers' applications and insufficient lender verification of applicants' nonfarm income and debts. Regarding insufficient loan collateral, FmHA regulations are unclear as to what constitutes proper and adequate security for guaranteed loans. Because the regulations allow for county supervisors to use subjective judgment in determining what is adequate security, inconsistencies arise among county offices in ensuring and documenting security backing the guaranteed loans.

Regarding the percentage of guarantee, FmHA regulations allow for guaranteeing a maximum of 90 percent of the loan principal and interest and describe various factors to consider in determining the percentage of guarantee. However, the regulations do not address how these factors should be used in either increasing or decreasing the percentage. Consequently, the unclear guidance has led to inconsistencies in percentage determinations among state and county offices, ranging from providing lower guarantees as the risk of loan loss increased, to providing maximum guarantees as the risk of loan loss increased. In addition, the unclear guidance did not result in a percentage of guarantee that (1) considered lenders' varying risks and (2) provided lenders the incentive to properly process and service guaranteed loans.

Problems in Overseeing Loan Guarantees After Approval

Lenders are responsible for servicing guaranteed loans and protecting loan collateral, and FmHA is responsible for overseeing lenders' servicing activities. However, we and the OIG found problems with FmHA's oversight of loan guarantees after approval. Lenders and/or FmHA were (1) not always obtaining periodic financial statements from borrowers nor always performing the required collateral inspections during the life of the loan, (2) making unauthorized loan advances to borrowers and including them under the guarantee, (3) not submitting timely default notices and/or liquidation plans, and (4) not pursuing recovery of losses after liquidation and FmHA's guaranteed loan loss payment to the lender. These problems have hindered FmHA's ability to identify problem loans early and to efficiently manage the liquidation process to minimize guaranteed loan losses.

Lenders and FmHA could not adequately determine borrowers' financial conditions and ensure that loans were adequately secured because periodic financial statements were not being obtained from the borrowers and collateral inspections were not being made. Further, lenders sometimes made and included advances under the guarantee when loss claims were submitted, causing FmHA to incur higher losses than should have been authorized--as much as $50,000 in one case. This occurred despite FmHA regulations stipulating that lenders should not make additional expenditures, new lines of credit, or new loans to borrowers with FmHA guaranteed credit without first obtaining written FmHA approval, even when such expenditures or lines of credit or loans will not be guaranteed.

FmHA regulations require lenders to notify FmHA in a timely manner when borrowers are in default and to work with FmHA and the borrowers to attempt to cure the defaults. The regulations also require timely notification when lenders decide to liquidate loan accounts and FmHA's concurrence in the liquidation decisions. As we reported in our September 1989 report, lenders were not (1) submitting timely default notices and/or liquidation plans and (2) adequately documenting disposition of loan security.

FmHA's current regulations do not require either lenders or FmHA to try to recover from borrowers the loss claims paid by FmHA to lenders. FmHA regulations only require that once liquidations occur and FmHA has made final loss payments, any funds recovered in the future by the lenders must be prorated between FmHA and the lenders on the basis of the percentage of guarantee. FmHA does not consider guaranteed loan loss claims paid to lenders to be indebtedness owed FmHA by borrowers. Because lenders only liquidate security property and are paid a percentage of any loss by FmHA in accordance with the guarantee, lenders have no real incentive--and FmHA does not require them--to pursue future recovery of loan losses. Consequently, loss amounts that might be recovered, at least to some degree, are not recovered, and borrowers can continue to operate using assets not liquidated under the guaranteed loan. Further, the defaults do not prevent these borrowers from obtaining future FmHA guaranteed or direct loans.

In our September 1989 report we included three case studies involving borrowers who had defaulted on FmHA-guaranteed loans to illustrate many of the problems we identified. The three case studies are included as appendix II.

IMPROVED MANAGEMENT OF FmHA'S GUARANTEED FARM LOAN PROGRAM IS NEEDED

To help control losses and improve management of the guaranteed farm loan program, we recommended in our September 1989 report that the Secretary of Agriculture direct the Administrator, FmHA, to

-- develop, in consultation with the Congress, and implement more comprehensive guaranteed loan-approval criteria that assess an applicant's financial solvency, profitability, liquidity, and repayment ability prior to approving loan guarantees;

-- establish in regulations the type and amount of security required for a guarantee and, if crops are accepted as the only security, require that crop insurance be obtained;

-- establish a range of loan guarantee percentages based on loan risk, with the higher guarantee percentages going to lower risk loans;

-- enforce FmHA requirements for lender servicing of guaranteed loans and place greater emphasis on establishing the extent to which lenders' negligent servicing caused loan losses before determining the amounts to be paid as loss claims; and

-- establish in regulations procedures for recovering from defaulted borrowers amounts the government paid to lenders for guaranteed loan losses.

We also recommended that the Secretary of Agriculture direct the Administrator, FmHA, to provide (1) county supervisors with training in credit analysis to better acquaint them with what constitutes adequate financial data on which to base a guaranteed loan-approval decision and (2) guidance and training to state, district, and county officials that would enhance the monitoring of lenders' guaranteed loan-servicing activities, especially guaranteed loan liquidations.

USDA generally agreed with most of our findings and recommendations. However, some of its actions planned or underway may not fully resolve some of the problems that led to the recommendations. USDA disagreed on the need to establish procedures for recovering government losses from defaulted borrowers, but agreed to further study the issue. We continue to believe that recovery action should be pursued against borrowers who may have assets available to reimburse the government's losses. According to USDA, a contracted study of the program's loan approval and borrower selection criteria will consider most of our recommendations, including the recovery of loan losses. This contract, which covers both direct and guaranteed farm loans, was awarded on September 28, 1989.

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USDA recently announced its farm credit proposals for the 1990 Farm Bill. USDA proposes to modify the guaranteed farm operating loan program to (1) facilitate the transition of existing direct loan borrowers to guaranteed loans and ultimately to private sector credit and (2) provide a source of assistance to private lending institutions' current borrowers who can no longer continue with those lenders on commercial terms. USDA also proposes to modify the guaranteed farm ownership loan program to target it to beginning farmers and those who wish to expand family farms. Another proposal will create a new interest subsidy program for guaranteed loans as a further incentive to encourage the shift from direct lending to private lending guaranteed by FmHA.

These proposals assume that commercial lenders will vastly increase their participation in the guaranteed farm loan program. Our previous work on FmHA's guaranteed farm loan program and the IRR program, as highlighted in my testimony today, raises doubts about whether this will occur. We believe it is extremely important for the Congress to examine these proposals closely to evaluate the likelihood that the commercial lending community will support such proposals.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions.

FmHA Guaranteed Farm Loans and Delinquency Status, September 30, 1989[a]

Dollars in Millions

	Farm ownership	Farm operating	Other[b]	Total
Total borrowers[c]	5,549	23,670	797	30,016
Delinquent borrowers[c]	300	1,063	217	1,580
Delinquent borrowers as a percent of total	5.4	4.5	27.2	5.3
Total outstanding principal	$772	$2,371	$101	$3,244
Outstanding principal owed by delinquent borrowers	$44	$120	$33	$197
Outstanding principal owed by delinquent borrowers as a percent of total	5.7	5.1	32.7	6.1

[a] According to FmHA's Finance Office, the information presented in this table does not include IRR program data.

[b] This category includes all other guaranteed farm loans, such as emergency livestock loans.

[c] This table presents data by loan type rather than individual borrower, which results in borrowers being counted in each loan category in which they have a loan.

Source: GAO analysis of FmHA Analysis of Delinquencies Report data (FmHA report code 4067).

CASE STUDIES OF GUARANTEED FARM LOAN PROGRAM BORROWERS WHO HAD DEFAULTED ON THEIR LOANS

In our report entitled Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86; Sept. 11, 1989) we provide three case studies on borrowers who had defaulted on FmHA-guaranteed loans to illustrate many of the problems we identified. The three case studies from that report follow.

Case Study A

A borrower received an operating loan in April 1986 for about $118,000, which FmHA guaranteed at 90 percent. This loan was for production purposes and to make payments to other creditors for the borrower's son. The borrower listed no debts and total assets of $215,000. The assets consisted of $10,000 in cash, $145,000 in savings, and $60,000 in real estate. It appeared that the borrower had sufficient collateral to obtain a loan without the FmHA guarantee. However, the guaranteed loan was secured only by a crop lien and assignment of ASCS payments on 600 acres of cotton and soybeans. The borrower had no crop insurance and leased land from his son for farming purposes.

The county supervisor indicated on the guaranteed loan evaluation form that the security offered (crops) appeared adequate and that the borrower had been unable to obtain necessary credit without a guarantee. The county supervisor's evaluation of the borrower's inability to obtain credit without a loan guarantee appeared questionable because (1) a letter from the private lender accompanying the loan application did not state that credit would be denied without the guarantee and (2) the borrower had not signed the Conditional Commitment for Guarantee certifying that credit was not available at reasonable rates and terms.

The borrower's repayment estimate showed projected income from crop production of $112,750, government payments of $19,000, and other income of $5,900 for a total projected income of $137,650. Loan records showed the borrower was actually loaned $106,200 of the $118,000 approved and repaid only $72,781. Of this amount, $64,600 was applied to loan principal and $8,181 was for interest on the loan. In March 1987 the lender filed a loss claim with FmHA for $42,286, and in May 1987 FmHA paid the lender $38,409, including accrued interest until date of payment, to honor its 90-percent guarantee.

We identified several problems with this guaranteed loan. First, the loan guarantee request probably should not have been approved because sufficient assets, including cash and savings, were available to finance the farming operation without a loan guarantee. Second, one of the loan's purposes--payment of the borrower's son's debts--is not a permissible loan purpose under FmHA's regulations. Third, accepting crops as the only collateral without crop insurance and when over $200,000 in unencumbered security was available proved to be a costly mistake because FmHA paid the lender a loss claim of over $38,000. Finally, until our inquiry there was no evidence that either FmHA or the lender pursued recovery of this $38,000 from the borrower despite the apparent existence of ample assets on which to base a recovery.

Case Study B

In April and May 1985 a lender obtained two guaranteed loans for an existing borrower, a 1-year operating loan for $95,000 and a farm ownership loan for $275,000. The operating loan, secured by 1985 crops and guaranteed at 50 percent, was to be used for rent, crop production expenses, and the purchase of feeder pigs. The farm ownership loan, guaranteed at 90 percent, was to cover refinancing of past operating losses and capital expenditures. The farm ownership loan was secured by a third lien position on 400 acres of land and machinery. The lender agreed to write off $30,000 of the borrower's debt to help ensure survival and obtain the farm ownership loan guarantee. The farm ownership loan guarantee was approved by the FmHA state office because the loan amount exceeded the county supervisor's approval authority.

In September 1985 the lender sold the farm ownership loan on the secondary market. By January 1986 the borrower was in default on both loans, and the lender gave FmHA notice of default and proposed liquidation action. FmHA approved the liquidation of the loan accounts in April 1986. In June 1986 the lender advised FmHA that other lenders had claims of $778,000 against the 400 acres of land and that it was unlikely there would be any equity to protect on their lien. The lender obtained sufficient funds from the borrower to pay the balance due on the operating loan but filed a loss claim for the outstanding balance of $234,290 on the guaranteed farm ownership loan. The guaranteed loss amount was $210,861.

In reviewing the case file, the county supervisor found several problems that resulted in a recommendation against loss payment because of lender misrepresentation. Among these problems were the following:

-- The borrower made a major change in his farming operation between the time of loan application and loan closing that was not reported to FmHA, nor was revised financial data submitted to reflect the new operation.

-- An after-the-fact June 1986 lender submission of financial information on the revised farm operation, according to the county supervisor, overstated the projected income and the farmer's capacity to operate at the level indicated.

-- The lender omitted from the loan application a Federal Land Bank debt of $51,000 against the land, resulting in significantly overstating the collateral available to secure the third lien position on the farm ownership loan guarantee.

-- The land value shown in the borrower's January 1985 financial statement was significantly higher than that shown just prior to the liquidation decision in December 1985 ($936,600 versus $550,000), causing the county supervisor to question the reliability of the lender's appraisal submitted with the loan guarantee request.

In countering the county supervisor's recommendation, the lender maintained that the change in operation had been discussed with an FmHA state official, and this state official said that no new cash flow projection or amendment to the application was needed. The state official, however, could not recall such a conversation. The county supervisor maintained that, had he been informed of the change in operation and aware of the additional $51,000 lien against the farm, the loan guarantee request may have been denied.

The dispute over the loss claim continued for about 2 years during which time interest continued to accrue on the outstanding balance of the farm ownership loan. Another complicating factor was that the farm ownership loan note had been sold in the secondary market, and the holder was demanding the payments that the lender was supposed to collect and forward under the servicing agreement. On June 23, 1987, the lender acting on behalf of FmHA notified the holder to surrender to FmHA the guaranteed part of the loan and advised the holder to contact the FmHA county office to arrange for loss payment. On June 25, 1987, the holder demanded that the lender repurchase the unpaid guaranteed portion of the loan. The lender refused this request and again advised the holder to demand payment of the guarantee from FmHA.

According to a state official, FmHA submitted the required paperwork for payment of a loss claim of about $245,200 on May 13, 1988. However, at the time of our review, FmHA apparently still had a dispute with the lender over $6,000 that it believed the lender should pay FmHA. On June 2, 1988, FmHA finally paid the holder $247,735 to settle the loss claim.

This case study illustrates several program problems, including questionable loan approval, possible misrepresentation, questionable collection efforts, and an untimely loan loss payment. The questionable loan approval and other subsequent events resulted in a loss to FmHA of over $200,000, and, in not settling this loss claim promptly, FmHA incurred additional losses of about $40,000 because of interest accrual.

Case Study C

This borrower received two operating loans that FmHA guaranteed at 90 percent in May and June 1986--a $267,580 line of credit for production expenses and a $78,900 loan note guarantee to refinance three pieces of equipment. The line of credit was secured by a crop lien on soybeans, milo, and cotton to be planted on 2,756 acres. The loan note was secured by five pieces of equipment, which had an estimated value of $63,600 according to the borrower's financial statement. The maturity date on the line of credit was December 1, 1986.

The borrower's financial statement showed total assets of $335,200 and total liabilities of $754,667, for a negative net worth of $419,467. At the time of loan application, the borrower had nine outstanding direct loans from FmHA with a total loan amount of about $345,000. Four of the loans were delinquent but were rescheduled and brought current in order to approve the loan guarantees.

In August 1987 the lender requested in a letter to the county supervisor that FmHA pay its 90-percent guarantee on the line-of-credit production loan. The lender advised FmHA that the borrower had paid a total of $208,423 of the $267,272 advanced under the line of credit, but the lender had advanced the borrower an additional $12,674 to cover certain harvesting expenses, resulting in a principal balance shown by FmHA of $71,431 (although the net amount would appear to be $71,523). With accrued interest on the outstanding principal remaining, the amount of loss claim on the line of credit was $74,090, and FmHA paid the lender $66,681 to honor the guarantee.

From the borrower's loan file, the lender's letters to FmHA, and discussions with the loan officer and FmHA officials, we identified the following problems with this case.

- The loan file contained no county committee certification of loan eligibility and no loan evaluation form.
- The borrower was technically insolvent with a negative net worth of over $400,000 and had a series of FmHA direct

loans, some of which required rescheduling prior to approval of the loan guarantees, indicating that approving an operating loan guarantee with crops as the only security at 90 percent was highly risky.

-- The lender released $12,674 of crop proceeds to the borrower to cover certain harvesting expenses without obtaining the required FmHA approval for making the advance and, contrary to FmHA regulations, included this advance in the loss claim. FmHA included the advance in settlement of the loss claim, which resulted in FmHA's paying a loss that exceeded 90 percent of the unpaid balance of the loan.

-- The lender did not provide FmHA a notice of default or a liquidation plan prior to submitting a loss claim about 8 months after the maturity date of the line-of-credit guarantee.

According to the lender and FmHA officials, the borrower continued to farm in 1987 despite the liquidation of the line-of-credit guarantee and FmHA's payment of a loss claim to the lender. The borrower still experienced financial problems, however, as demonstrated by the fact the he made no payments on his FmHA direct loans or on the guaranteed portion of the line-of-credit loan. In view of the borrower's past and continuing financial problems, we asked FmHA state officials of their rationale for guaranteeing loans at 90 percent to this borrower. Their response follows.

> "Our policy is to allow the maximum guarantee in cases involving financial statements such as that produced by the borrower provided the security value and repayment ability are realistically projected as adequate. Cases in this category are often salvable and lenders would not make loans to this type client without a guarantee as additional security. However, in cases projecting more than adequate security and other unencumbered assets with very marginal repayment ability, our policy is to grant less than a maximum guarantee because the lender's exposure is less and the government's protection from losses are needed to a much lesser degree."

This case study illustrates how loan losses can result from inadequate (1) evaluation of a borrower's financial condition prior to approving a loan guarantee request, particularly the assessment of collateral backing the loan and the determination of the percentage of guarantee and (2) monitoring of a lender's servicing activities, particularly approving lender advances to borrowers and requiring proper and timely submission of default notices and liquidation plans.

Senator **Conrad**. Thank you very much. Next we will turn to Ms. Roth, attorney for the Farmers' Legal Action Group. Welcome.

STATEMENT OF RANDI ILYSE ROTH, ATTORNEY AT LAW, FARMERS' LEGAL ACTION GROUP, INC., ST. PAUL, MN

Ms. **Roth**. Thank you, Mr. Chairman.

INTRODUCTION

Mr. Chairman, Senators I want to thank you for inviting Farmers' Legal Action Group to testify here, and I would like to explain that I am testifying on behalf of the FmHA borrowers who we represent and associate with nationwide.

FLAG

Farmers' Legal Action Group (FLAG) is a nonprofit law firm. We have five attorneys and we have all been actively involved in Farmers Home issues for the last 6 years. We focus in three areas: litigation, education, and support.

In litigation we focus on class action litigation mostly on behalf of FmHA borrowers. We were the attorneys in the *Coleman* case where we represented 230,000 FmHA borrowers and challenged FmHA's notice and litigation procedures where the court found that FmHA's procedures were illegal.

In terms of education, we travel and speak to groups of farmers and ranchers and their attorneys and advocates nationwide. To date, we have had total attendance of over 12,000 farmers and ranchers and lawyers. And we have an opportunity to gather a lot of information being on the road and talking to farmers and ranchers.

In terms of support, we take phone calls from lawyers and farmers and ranchers and their advocates from all over the country all day. So that is another opportunity for us to gather information about what is really happening in the field.

As a final introductory comment, I want to explain that I have not submitted 100 pages of testimony. This is 11 pages of testimony and an attachment which is—we produce a book periodically called the "Farmers' Guide to FmHA" that explains to farmers and ranchers what their rights are if they borrow from FmHA. The attachment that I have given to you is the chapter from the latest edition on the guaranteed loan program. So it explains farmers and ranchers rights in that program.

Senator **Conrad**. Could you read that entire attachment, please?

Ms. **Roth**. And in 10 minutes, right? I am from Chicago, but I cannot read that fast. What I will do is——

Senator **Boschwitz**. I thought you were from Minnesota?

Ms. **Roth**. I have been in Minnesota for 4 years. I moved there to take this job.

Senator **Conrad**. She is a strong supporter of yours, Rudy, so be very kind.

Senator **Boschwitz**. They are moving in, as you see. [Laughter.]

Senator **Conrad**. I think it is because of the Governor in Minnesota that they are moving in.

Ms. ROTH. What I would like to do is read portions of the testimony that I have submitted, knowing that the entire testimony will be part of the record.

THE FOCUS OF THESE COMMENTS

My testimony will focus on two areas: First, the problems experienced by borrowers in the guaranteed lending programs because that is where we have the most expertise; and second, briefly on the need for continued direct FmHA lending.

PROBLEMS ENCOUNTERED BY BORROWERS IN THE FMHA GUARANTEED LOAN PROGRAM

A shift in funding from the direct to the guaranteed loan program brings with it a fundamental shift away from borrowers' rights. On the surface, the guaranteed loan program seems to provide borrowers with protections similar to those in the direct loan programs; the loan servicing tools in the guaranteed program, for example, have the same names as the tools in the direct loan program, such as rescheduling, deferrals, write-downs. The way the borrower protections work in the two programs, though, is as different as night and day.

The Agricultural Credit Act of 1987 had two complementary goals: to require FmHA to act in the manner that is most economical for the Government; and to require FmHA to act to preserve existing farming operations whenever that makes economic sense. The shift from direct to guaranteed lending takes us farther from, not closer to, those goals.

NINE AREAS IN WHICH THE SHIFT IS A PROBLEM

I am going to talk about nine areas in which the shift is a problem, but the bulk of my comments will focus on the first areas. That is where also all of the time will be.

NO RIGHT TO LOAN SERVICING

The first is there is no right to loan servicing in the guaranteed loan program.

"Loan servicing" is a term used to refer to a series of seven tools that can be used to change a borrower's repayment obligations. The loan servicing tools in the guaranteed loan program are almost exactly the same as the tools that are available in the direct loan program.

The loan servicing tools range from those which merely rearrange the payment schedule on a fixed amount of debt. Those are called rescheduling, reamortization, consolidation to those which actually reduce the amount of debt a farmer owes, and that is the write-down program. The loan servicing programs as a whole have two goals—the same goals as the goals under pending the Agricultural Credit Act—one, to save money for the Government, and two, to preserve existing farming operations whenever that is the most economical option for the Government. The loan servicing programs accomplish the first goal by allowing the farmer to pay a restructured debt when that when that will bring a greater net recovery to the Government than forced liquidation or foreclosure.

The loan servicing programs accomplish the second goal by allowing the farmer to enter into a workout that enables him or her to stay on the farm.

In both the guaranteed and direct programs, a farmer must meet certain eligibility criteria in order to qualify for loan servicing assistance. In the direct program, if the farmer meets those eligibility criteria, he or she is *entitled* to receive the benefit of loan servicing assistance. Because of that entitlement, it is said that farmers in the direct loan program *have a right* to loan servicing assistance if they meet the relevant eligibility criteria. *There is no corresponding right to loan servicing assistance in the guaranteed loan program.* In the guaranteed program, if a farmer meets the eligibility criteria for loan servicing, he or she has only a mere *chance* of obtaining loan servicing assistance. I would submit that this is one of the reasons why the guaranteed loan program is losing money right now. Even if the farmer met the eligibility criteria, he or she would still have to cross at least three additional barriers that make loan servicing extremely difficult to obtain in the guaranteed loan program.

THREE BARRIERS TO LOAN SERVICING

I will briefly discuss those three barriers.

The first is that lenders are not notified about loan servicing options in the guaranteed loan program. The Agricultural Credit Act of 1987 created a debt write-down program for guaranteed loans for the first time. Debt write-down can allow farmers to continue farming if they cannot cash-flow their entire debt, but they can cash-flow a somewhat reduced debt—provided that the payments on the reduced debt will result in a greater net recovery to the Government than forced liquidation would. Debt write-down is an extremely powerful loan servicing tool—it can greatly help the agency's efforts to meet the dual goals of the Agricultural Credit Act.

Although the Agricultural Credit Act became effective on January 6, 1988, FmHA did not implement the debt write-down program for guaranteed loans until January 13, 1989, the date its final guaranteed regulations became effective. Despite the fact that now more than 2 years have passed since the Agricultural Credit Act became effective, FmHA has never sent a notice to lenders to inform them of the existence of the write-down program. And I will add that in my travels meeting with bankers and with farmers, it has been my experience that bankers do not know about the program. And Senator, I was recently in Lehr, North Dakota—actually in Wishek—where the bank had just failed and I met with all the bankers up in that area who came to the meeting, and none of them knew of the existence of a debt write-down program. So I think one could assume that also the bank that failed did not know of the existence of the program and could not avail itself of those benefits prior to the failure.

This lack of notice is especially problematic because FmHA historically flatly refused to allow any kind of guaranteed loan write-down. The situation changed when the January 13, 1989 regulations became effective, *but hardly anybody knows that it has changed.* One layer of the problem, then, is that most lenders do not know that a write-down program is available to help their borrowers. Another layer is that even those lenders who do know of the existence of the program probably do not know about the fairly complicated details of how the program works and what its eligibility criteria are. Lenders would have no way of knowing about these details unless they happened to hear about the program and took the initiative to obtain and decipher FmHA's regulations or unless they happened to obtain a copy of one of our publications or learned about it in some other way on their own.

The debt write-down program is an important example of FmHA's failure to give notice to lenders. The same lack of notice problem also appears in the other guaranteed loan servicing programs. The rescheduling, reamortization, deferral, and interest rate buy-down programs all have detailed eligibility criteria which are explained in the attached chapter of "Farmers' Guide". However, FmHA provides no descriptive notice of the workings of those programs to its lenders, as it does in the direct program.

In the direct program, FmHA sends borrowers and county office staff detailed notices explaining the benefits of and eligibility criteria for its loan servicing programs, partly as a result of the *Coleman* litigation. In the guaranteed loan program, though, FmHA sends no notices. Therefore, in the guaranteed loan program, it is not enough for a farmer to simply meet the eligibility criteria. A farmer must also somehow happen to cross the knowledge barrier by finding out about the existence of and eligibility criteria for the loan servicing programs and by providing this information to his or her lender. So that was barrier number one which is knowledge.

THE LENDER HAS DISCRETION

The second barrier to loan servicing is that the lender has discretion. In the guaranteed loan program, the lender has *discretion* as to whether he or she will provide the farmer with loan servicing assistance. If the farmer meets the eligibility criteria for assistance, that simply means that the lender *may* provide the assistance—it does not mean that the lender *must* provide the assistance. The lender may choose not to restructure the loan even if restructuring is the most commercially reasonable choice, and therefore the most economical choice for the Government.

FMHA MUST APPROVE LOAN SERVICING ACTIONS

The third barrier is that FmHA must approve loan servicing actions. If a farmer finds out about loan servicing, applies for it, meets the criteria for it, and has a lender who knows about it, wants to provide it, there is still one more hurdle to cross: FmHA approval. Farmers are reporting to me that in those instances in which a banker and a farmer pursue loan servicing together, FmHA often denies the applications without adequate explanations of the reasons for the denial. In those cases, the lender is often afraid to appeal the denial, and I will discuss appeal problems in a moment.

THE LENDER'S DISCRETION IS EFFECTIVELY UNBRIDLED

There are three clauses in the lenders' agreement, which is a contract signed by the lender and FmHA, that encourage the lender to exercise its discretion in a commercially reasonably manner. The three clauses are explained in detail in the attached "Farmers' Guide" chapter. Briefly, those clauses require that:

First, the lender must negotiate in good faith.

Second, the lender must consider the borrower for loan servicing.

Third, the lender must perform the services in a manner in which a reasonably prudent lender would service its own portfolio of loans that are not guaranteed.

And if you just look at those clauses, they would seem to indicate that discretion would be exercised in a reasonable manner. In practice that is not what happens.

There are two problems with these clauses from the lender's agreement. First, lenders are not following the dictates of these clauses. Almost all of the farmers whom I have interviewed regarding guaranteed loan problems, for example, what I have been hearing is that the lender has skipped over the required "meeting upon default" at which these negotiations are supposed to take place. The reasons for lender noncompliance with the contract vary. I would guess that in some cases, the contract violations are happening because the lenders do not understand what they are supposed to do or what types of loan servicing are available. The second problem is that when farmers have gone into court to try to enforce the right that they think that they have because of these clauses, they have been unable to sue. It is sort of the Farm Credit System problem with the private right of action. The courts have been holding in the contract between the lender and FmHA, the farmer-borrowers are not third-party beneficiaries of the lender's agreement. We had a first circuit court ruling on *Harper* v. *USDA* coming down that way.

So the upshot of that is those clauses in the lenders' agreement do not do any good for the farmers. So overall there is no true right to get loan servicing in this program.

JOINT APPEALS DO NOT WORK

The second major area I want to discuss of problems is the appeals system. Joint appeals do not work. In the direct loan program, a borrower or applicant can appeal any adverse action taken by FmHA. Now the statute that governs the guaranteed program is written in the same way. The farmer should be able to appeal any adverse action. However, in the regulations for the guaranteed loan program, farmers can only appeal if a banker will appeal with the farmer. It does not work. It is very rare that lenders are willing to appeal with farmers.

One reason for the lenders' reluctance is the lender's fear that if they "cause any trouble," FmHA will find reasons to comb through their remaining portfolio of guaranteed loans and pull guarantees. So the appeals system is a disaster, and I will also add that the statistics that are coming out in the direct loan program is that we are having close to, I believe, a 50 percent reversal rate on appeal which means essentially that 50 percent of the county level decisions are wrong.

Now I would imagine that at least that percentage of wrong decisions are being made in the guaranteed loan program, but guaranteed loan borrowers are left with essentially no redress because the appeals system just does not work the way it is structured. Those were the two major areas of problems.

I will briefly highlight the remaining areas.

LENDERS SEEM RELUCTANT TO MAKE GUARANTEED LOANS

The third area is that lenders seem reluctant to make guaranteed loans. My understanding is that it is a combination of reasons. That there is administrative hassles. There is paperwork. And I would like to point out that the reason I am hearing most often for reluctance is that now some guarantees are being offered at lower than 90 percent guarantee levels—60, 70, 80 percent which obviously increases the lenders risk and lenders are even less willing to make guaranteed loans in that scenario.

PRINCIPAL IS WRITTEN DOWN BEFORE INTEREST

The fourth problem is that under the current regulations when there is a rate done on guaranteed loans, the regulations require that principal be written down before interest which has serious adverse tax consequences for the borrower.

NO PROVISIONS FOR RELEASE OF INCOME

The fifth area of problem is that there is no provisions for release of income. Briefly in the direct loan program, if a farmer needs the lender to release its security interest in farm production income for essential family living or farm operating expense, the farmer has a limited right to obtain those releases. There is no corresponding right in the guaranteed loan program which means that lenders can if they choose freeze farmers out of business by refusing to release income.

FARMERS ARE REQUIRED TO MAINTAIN A 10 PERCENT RESERVE

The sixth area of problem is that farmers are required to maintain a 10 percent reserve, the 110 percent cash-flow requirement that was addressed by the bankers previously, and I echo their comments.

NO NET RECOVERY VALUE BUYOUTS

The seventh area is that there is no net recovery value buyout program in the guaranteed loan program. Briefly in the direct loan program, if a farmer cannot qualify for loan servicing, so it seems that liquidation or foreclosure is imminent, the farmer can buy out the loan from the Government by paying the Government what it would get if it foreclosed. So it is economical for the Government, the Government recovers the same amount of money, and the farmer may be able to find a way to preserve his or her farming operation under that scenario.

That action does not exist in the guaranteed loan program.

NO NOTICES OF LOAN SERVICING

The eighth area is that there are no notices of loan servicing to borrowers or lenders. I discussed that previously.

LATE REGULATIONS

The ninth area is late regulations. The Agricultural Credit Act required FmHA to issue final regulations by June 4, 1988. Final regulations did not become effective, however, until January 13, 1989, over 7 months late. During that period, FmHA continued to approve liquidations and foreclosures under the old regulations, without giving farmers the benefit of the new protections, such as debt write-down and lower interest rates.

Those are the nine problems.

THE NEED FOR CONTINUED DIRECT LENDING

I would like to move now to discuss briefly the need for continued direct lending.

Continued and increased appropriations for FmHA Direct Operating and Farm Ownership loans are greatly needed. These direct lending programs must continue to allow family farmers to recover from the devastating economic crisis in agriculture of the 1980's and the recent widespread drought conditions.

For the last several years, FmHA has been running out of funds. The oversubscription that you addressed, Senator, appropriated for direct lending while eligible farmers' applications can be processed. At the same time, in 1988 FmHA obligated only 41.4 percent and in 1988 only 33.8 percent of its guaranteed loan authority.

Due to farmers' inability to meet the guaranteed loan eligibility requirements, especially their inability to pay the higher interest rates in the guaranteed loan program, and many banks' disinterest in the program, the guaranteed loan program will never effectively replace the need for or meet the purposes of the direct lending programs. This has remained true despite several years of concentrated effort by FmHA to encourage increased participation in the guaranteed loan programs.

RECOMMENDATIONS

I would like to summarize with nine recommendations:

First, continue and increase the funding to the direct lending program.

Second, conduct inquiries into FmHA practices to determine: (a) the extent to which farmers are able to appeal adverse decisions under the present appeals scheme and (b) the extent to which farmers are actually receiving loan servicing assistance, with particular emphasis on the extent to which farmers are receiving debt write-downs in the guaranteed program.

Third, change the appeals system in the guaranteed loan program to allow farmers to appeal, regardless of whether the banker joins in the appeal.

Fourth, explicitly provide that the farmer is a third-party beneficiary of the lender's agreement that is signed by the lender and

FmHA and which would essentially give the farmer a right to sue to enforce the lender's agreement.

Fifth, require FmHA to send a notice of its loan servicing programs to all borrowers and lenders in the guaranteed loan program. The notice should include a detailed description of the programs themselves and of the eligibility criteria for the programs—like FmHA sends out in the direct loan program.

Sixth, eliminate the requirement that principal must be written down before interest. Require instead that interest must be written down first.

Seventh, require that farm production income be released to the farmer when it is needed for essential family living or farm operating expenses.

Eighth, eliminate the 10 percent reserve cash-flow requirement.

Ninth, provide for a net recovery value buyout program.

That concludes my comments.

[The prepared statement and attachment, Guaranteed Loans, excerpt from Farmers' Guide to FmHA of Ms. Roth follow:]

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February 15, 1990

VIA FEDERAL EXPRESS

The Honorable Kent Conrad
United States Senate
328A Russell Senate Office Building
Washington, DC 20250

Attn: Mary Byrne

Dear Senator Conrad:

Re: FmHA Guaranteed Loans

I am writing at your office's request to provide information for the Senate Agriculture Subcommittee on Agricultural Credit hearing to be held on February 20, 1990. On behalf of the FmHA farmer program borrowers we represent, we thank you for your interest in exploring the problems experienced by lenders and borrowers in the FmHA guaranteed loan program and in exploring different views on the continuation of FmHA direct lending.

A. INTRODUCTION

Farmers' Legal Action Group, Inc.

Farmers' Legal Action Group (FLAG) is a nonprofit law firm representing farmers and ranchers around the country. The attorneys on our staff have been actively involved in FmHA issues for the past six years. Jim Massey and Lynn Hayes of our office represented a national class of approximately 230,000 FmHA farmer program borrowers in the *Coleman v. Lyng* lawsuit against the agency. That lawsuit effectively prevented FmHA from foreclosing or liquidating farmer program borrowers for most of the last five years because the court found that the methods employed by FmHA were illegal. FLAG has also represented FmHA farmer program borrowers in several other class action lawsuits. Congress addressed many of the issues raised in this litigation through the passage of the Agricultural Credit Act of 1987.

FLAG staff also travel all over the country speaking at training sessions for farmers, ranchers, and their advocates and lawyers. These events have been sponsored locally by 88 different organizations; some are national farm groups, some are church or legal organizations, and some are local, grass roots organizations. Total attendance at these gatherings has been 12,743; of these, 8,158 have been farmers, 2,706 lawyers, 1,228 advocates, and 651 a mix of public officials and interested citizens. At these training seminars, we have received a great deal of information about how FmHA is implementing its programs in various parts of the country.

In addition to the training seminars, we receive information about FmHA's activities from farmers, ranchers, and their lawyers and advocates through the hundreds of telephone calls we receive. We provide backup support and advice and analysis for attorneys and advocates representing farmers around the country.

Our organization also provides legal education materials which are available to farmers and ranchers and their lawyers and advocates. The materials we have produced that relate to FmHA are four editions of Farmers' Guide to FmHA; the Farm Survival Handbook and its accompanying VHS video tape; and a series of articles in our bimonthly newsletter, Farmers' Legal Action Report, including the "Special Report" on the Agricultural Credit Act of 1987.

Much of FLAG's work has focused on the FmHA guaranteed loan program. We have spoken at several training seminars for both farmers and bankers regarding guaranteed loans. Our office has done extensive analyses of proposed guaranteed loan regulations and has submitted comprehensive comments regarding the regulations.

The Attached Guaranteed Loan Chapter from Farmers' Guide to FmHA

As mentioned above, our office has produced four editions of the book entitled Farmers' Guide to FmHA, which was written to help farmers and ranchers to learn what their rights are in the FmHA lending programs. The first three editions of the guide sold more than 50,000 copies.

In the new fourth edition of Farmers' Guide, I wrote a detailed chapter that explains the workings of the FmHA guaranteed loan program from the farmer's perspective. That chapter is attached to this testimony. Throughout this testimony, I have made references to sections of that chapter.

The Focus of These Comments

My testimony will focus on two areas: (1) problems experienced by borrowers in the guaranteed loan program, and (2) the need for continued direct FmHA lending.

B. PROBLEMS ENCOUNTERED BY BORROWERS IN THE FmHA GUARANTEED LOAN PROGRAM

A shift in funding from the direct to the guaranteed loan program brings with it a fundamental shift away from borrowers' rights. On the surface, the guaranteed loan program seems to provide borrowers with protections similar to those in the direct program; the loan servicing tools in the guaranteed program, for example, have the same names as the tools in the direct program (rescheduling, deferrals, write-downs, etc.). The way the borrower protections work in the two programs, however, is as different as night and day.

The Agricultural Credit Act of 1987 had two complementary goals: to require FmHA to act in the manner that is most economical for the government and to require FmHA to act to preserve existing farming operations whenever that makes economic sense. The shift from direct to guaranteed lending takes us farther from, not closer to, those goals.

1. No Right to Loan Servicing

"Loan servicing" is a term used to refer to a series of seven tools that can be used to change a borrower's repayment obligations. The loan servicing tools in the guaranteed loan program are almost exactly the same as the tools in the direct program. The tools are described in detail in the attached Farmers' Guide chapter at pages 15.38-.47.

The loan servicing tools range from those which merely rearrange the payment schedule on a fixed amount of debt (for example, rescheduling and reamortization) to those which actually reduce the amount of debt the farmer owes ("debt write-down"). The loan servicing programs as a whole have two goals: (1) to save money for the government, and (2) to preserve existing farming operations whenever that is the most economical option for the government. The loan servicing programs accomplish the first goal by allowing the farmer to pay a restructured debt when that will bring a greater net recovery to the government than forced liquidation or foreclosure. The loan servicing programs accomplish the second goal by allowing the farmer to enter into a workout that enables him or her to stay on the farm.

In both the guaranteed and direct programs, a farmer must meet certain eligibility criteria in order to qualify for loan servicing assistance. In the direct loan program, if a farmer meets those eligibility criteria, he or she is entitled to receive the benefit of loan servicing assistance. Because of that entitlement, it is said that farmers in the direct loan program have a right to loan servicing assistance if they meet the relevant eligibility criteria. There is no corresponding right to loan servicing assistance in the guaranteed loan program. In the guaranteed loan program, if a farmer meets the eligibility criteria for loan servicing, he or she has only a mere chance of obtaining loan servicing assistance. The farmer would still have to cross at least three additional barriers that make loan servicing extremely difficulty to obtain in the guaranteed loan program.

a. Three Barriers to Loan Servicing

(1) Lenders Are Not Notified About Loan Servicing Options. The Agricultural Credit Act of 1987 (the "Credit Act") created a debt write-down program for guaranteed loans for the first time. Debt write-down can allow farmers to continue farming if they cannot cash flow their entire debt but can cash flow a somewhat reduced debt (provided that the payments on the reduced debt will result in a greater net recovery to the government than forced liquidation). Debt write-down is an extremely powerful loan servicing tool--it can greatly help the agency's efforts to meet the dual goals of the Credit Act.

Although the Credit Act became effective on January 6, 1988, FmHA did not implement the debt write-down program for guaranteed loans until January 13, 1989 (the date its final guaranteed loan regulations became effective). Despite the fact that more than two years have passed since the Credit Act became effective, FmHA has never sent a notice to lenders to inform them of the existence of the write-down program. In a public forum in Oklahoma City in September 1989, Jim Raidintz of FmHA's national office indicated that FmHA has no intention of ever sending such a notice.

This lack of notice is especially problematic because FmHA historically flatly refused to allow any kind of guaranteed loan write-down. The situation changed when the January 13, 1989 regulations became effective, but hardly anybody knows that it has changed. One layer of the problem, then, is that most lenders do not know that a write-down program is available to help their borrowers. Another layer is that even those lenders who do know of the existence of the program probably do not know about the fairly complicated details of how the program works. (See attached Farmers' Guide chapter at pages 15.43-.46 and 15.48-.50.) Lenders would have no way of knowing about these details unless they happened to hear about the program and took the initiative to obtain and decipher FmHA's regulations or unless they happened to obtain a copy of Farmers' Guide from FLAG.

The debt write-down program is an extreme and important example of FmHA's failure to give notice to lenders. The same lack of notice problem also appears in the other guaranteed loan servicing programs. The rescheduling, reamortization, deferral, and interest rate buy-down programs all have detailed eligibility criteria. (See attached Farmers' Guide chapter at pages 15.38-.51.) However, FmHA provides no descriptive notice of the workings of the problems to its lenders.

In the direct loan program, FmHA sends borrowers and county office staff detailed notices explaining the benefits of and eligibility criteria for its loan servicing programs. In the guaranteed loan program, though, FmHA sends no notices. Therefore, in the guaranteed loan program, it is not enough to simply meet the loan servicing eligibility criteria. A farmer must also somehow happen to cross the knowledge barrier by finding out about the existence of and eligibility criteria for the loan servicing programs and by providing this information to his or her lender.

(2) The Lender Has Discretion. In the guaranteed loan program, the lender has discretion as to whether he or she will provide the farmer with loan servicing assistance. If the farmer meets the eligibility criteria for assistance, that simply means that the lender may provide the assistance--it does not mean that the lender must provide the assistance. The lender may choose not to restructure the loan even if restructuring is the most commercially reasonable choice.

(3) FmHA Must Approve Loan Servicing Actions. If a farmer finds out about loan servicing, applies for it, meets the criteria for it, and has a lender who wants to provide it, there is still one more hurdle to cross: FmHA approval. Farmers are reporting that in the rare instances in which a banker and a farmer pursue loan servicing together, FmHA often denies applications without adequate explanations of the reasons for the denial. In those cases, the lender is often afraid to appeal the denial. (See the explanation of appeals problems below.)

b. The Lender's Discretion Is Effectively Unbridled

There are three clauses in the Lender's Agreement (a contract signed by FmHA and the lender) that encourage the lender to exercise its discretion to provide loan servicing when that is the "commercially reasonable" thing to do. The three clauses are explained in detail in the attached Farmers' Guide chapter at pages 15.37-.38. Briefly, those clauses require that:

(1) The lender must negotiate in good faith;

(2) The lender must consider the borrower for loan servicing; and

(3) The lender must perform the services that a "reasonably prudent" lender would perform in servicing its own portfolio of loans that are not guaranteed.

Additionally, the Lender's Agreement provides that when a borrower becomes delinquent, there is supposed to be a "meeting upon default" at which the farmer, the lender, and FmHA discuss loan servicing options.

There are two problems with these clauses from the Lender's Agreement. First, lenders are not following the dictates of these clauses. Almost all of the farmers whom I have interviewed regarding guaranteed loan problems, for example, stated that the lender skipped over the "meeting upon default" step in the process. The reasons for lender noncompliance with the contract vary. In some cases, the contract violations happen because the lenders do not understand what they are supposed to do or what types of loan servicing are available. The second problem is that farmers have not been successful in asserting the right to enforce these clauses in court. Only one case asserting that right has reached the federal circuit courts of appeal. In Parker v. USDA, 879 F.2d 1362 (6th Cir. 1989), the court held that farmer-borrowers are not third-party beneficiaries of the Lender's Agreement. This means that if a lender fails to negotiate in good faith or fails to hold a meeting upon default, there is nothing the farmer can do about it.

c. Overall, There Is No Right to Get Loan Servicing

If a farmer is eligible for loan servicing in the guaranteed loan program, he or she must still overcome several barriers: the farmer must find a way to learn about loan servicing, the farmer must educate his or her lender about loan servicing, the lender must want to provide loan servicing, and FmHA must approve the loan servicing plan. The farmer has no way to force the lender to keep the exercise of its discretion within proper guidelines. All in all, farmers in the guaranteed loan program may have a chance of obtaining loan servicing, but they do not have a right to it. This means that there are probably many cases in which lenders foreclose on farmers (or pursue other means of voluntary liquidation) when preserving the farming operation would have been a more economical result for the government and the lender.

2. Joint Appeals Do Not Work

In the direct loan program, a borrower or applicant can appeal any adverse action taken by FmHA. In the guaranteed loan program, the farmer cannot appeal unless the lender joins in the appeal. (See the attached Farmers' Guide chapter at page 15.56.)

The joint appeals system simply does not work. It is very rare that lenders are willing to appeal with farmers. One reason for the lenders' reluctance is the lender's fear that if they "cause trouble", FmHA will find reasons to terminate their guarantees on other loans held in the lenders' portfolios.

3. Lenders Seem Reluctant to Make Guaranteed Loans

Farmers report that many of the lenders they approach simply refuse to do business with the FmHA guaranteed loan program. Reasons given by the lenders include burdensome paperwork requirements, administrative hassles, and the fear that "one wrong move" will cause the guarantee to be cancelled. Also, farmers report that lately FmHA has been requesting that guarantee levels be substantially below 90 percent--some have reported that FmHA requests that guarantee levels be as low as 60 or 70 percent. Lenders are even less reluctant to enter into guarantees at these levels.

4. Principal Is Written Down Before Interest

When a farmer does obtain a write-down in the guaranteed loan program, principal must be written down before interest. (See the attached Farmers' Guide chapter at page 15.46.) This regulatory requirement has serious adverse tax consequences for the farmer.

5. No Provisions for Release of Income

In the direct loan program, FmHA is required to release proceeds from the sale of chattel security property to the farmer in certain situations if the farmer needs the money for essential family living or farm operating expenses. In the guaranteed loan program, there is no provision for release of income.

6. Farmers Are Required to Maintain a 10 Percent Reserve

To show a "positive cash flow" in the guaranteed loan program, the farmer must show that his or her income is at least 110 percent of his or her anticipated expenses. (See attached Farmers' Guide chapter at pages 15.27-.29.) This requirement makes it very difficult for farmers to qualify for guaranteed loans.

There is no parallel requirement in the direct loan program; there, a 100 percent cash flow is sufficient.

Additionally, the 110 percent cash flow requirement creates great confusion. Different parts of the guaranteed loan program have different cash flow requirements. Some parts of the guaranteed loan program have only a 100 percent cash flow requirement. (See attached Farmers' Guide chapter at page 15.27.) Farmers report that the different cash flow requirements in different parts of the program cause great problems because lenders and county office staff do not understand how the different cash flow requirements fit together. Because of their lack of understanding, they are often paralyzed and choose to take no action.

7. No Net Recovery Value Buyouts

The direct loan program provides that if loan servicing cannot be used to preserve the farming operation in a manner that is economical for the government, the farmer can "buy out" his or her loan. The buyout price is the amount of money the government expects to recover from an involuntary liquidation. This program allows the farmer to preserve his or her operation if he or she can find financing for the buyout.

There is no parallel provision in the guaranteed loan program.

8. No Notices of Loan Servicing

As explained above, FmHA does not provide notice of its loan servicing programs to either guaranteed loan lenders or borrowers.

9. Late Regulations

The Credit Act required FmHA to issue final guaranteed loan regulations by June 4, 1988. However, FmHA did not issue final regulations until January 13, 1989--over seven months late. During those seven months, FmHA continued to approve liquidations and foreclosures under the old regulations, without giving farmers the benefit of the new protections (such as debt write-down and lower interest rates).

C. THE NEED FOR CONTINUED DIRECT LENDING

Continued and increased appropriation for FmHA direct operating and farm ownership loans are greatly needed. These direct lending programs must continue to allow family farmers to recover from the devastating economic crisis in agriculture of the 1980s and the recent widespread drought conditions.

For the last several years, FmHA has been running out of funds appropriated for direct lending before all eligible farmers' applications can be processed. At the same time, in 1988 FmHA obligated only 41.4 percent and in 1988 only 33.8 percent of its guaranteed loan authority.

Due to farmers' inability to meet the guaranteed loan eligibility requirements (especially their inability to pay the high interest rates in the guaranteed loan program) and many banks' disinterest in the program, the guaranteed loan programs will never effectively replace the need for or meet the purposes of the direct lending programs. This has remained true despite several years of concentrated effort by FmHA to encourage increased participation in the guaranteed loan programs.

D. RECOMMENDATIONS

1) Continue and increase the funding to the direct lending program.

2) Conduct inquiries into FmHA practices to determine:

   a) The extent to which farmers are able to appeal adverse decisions under the present appeals scheme.

   b) The extent to which farmers are actually receiving loan servicing assistance (with particular emphasis on the extent to which farmers are receiving debt write-downs).

3) Change the appeals system to allow farmers to appeal, regardless of whether the lender joins in the appeal.

4) Explicitly provide that the farmer is a third-party beneficiary of the Lender's Agreement that is signed by the lender and FmHA.

5) Require FmHA to send a notice of its loan servicing programs to all borrowers and lenders in the guaranteed loan program. The notice should include a detailed description of the programs themselves and of the eligibility criteria for the programs.

6) Eliminate the requirement that principal must be written down before interest. Require instead that interest must be written down first.

7) Require that farm production income be released to the farmer when it is needed for essential family living or farm operating expenses.

8) Eliminate the 10 percent reserve cash flow requirement.

9) Provide for a net recovery value buyout program.

Sincerely,

FARMERS' LEGAL ACTION GROUP, INC.

Randi Ilyse Roth /acp

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RIR/acp
Attachment

Chapter 15

Guaranteed Loans

Excerpt from

Farmers' Guide to FmHA

November 1989

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Chapter 15

Guaranteed Loans

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Introduction

☐ Guaranteed Loans Are Different From Direct Loans

Up to this point, all of the information in this book has been about FmHA's **direct** loan programs.[1] In those programs FmHA is the lender. In a **guaranteed** loan, FmHA is **not** the lender. A commercial bank, Production Credit Association, Federal Land Bank, or other financial institution is the lender.

The guarantee says that if you do not pay back the loan, FmHA will pay most of it back. (FmHA will pay back up to 90 percent of the amount owed on the loan.[2]) By giving the lender a guarantee, FmHA reduces the lender's risk.

> **Guaranteed Loan**
>
> FmHA guarantees a loan that another lender makes to you. The guarantee says that if you do not pay back your loan, FmHA will pay most of it back (up to 90 percent of what is owed).

Remember that in guaranteed loans there are always at least three actors: you, the lender, and FmHA. Sometimes there is also a fourth actor who is called a **holder.**

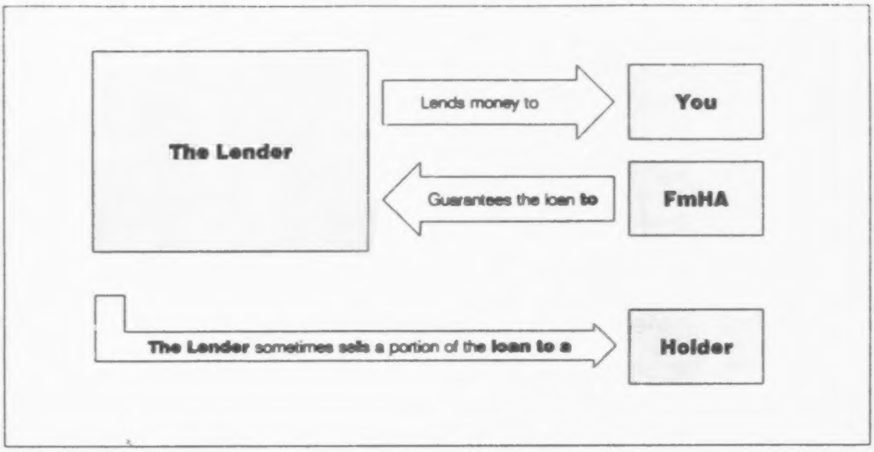
> **Holder**
>
> The lender has the right to *sell a portion* of the guaranteed loan to raise cash for itself. The party who buys the portion of the loan is called a holder.[3] The holder does not service the loan; the lender keeps all of the responsibility for servicing the loan.

---

[1] Direct loans are sometimes called "insured" loans because the money comes from something called the "insurance fund."

[2] You and the lender propose the percentage of guarantee to FmHA. The maximum guarantee in most cases is 90 percent. 54 Fed. Reg. 1548 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.20). (For some demonstration project loans, the guarantee can be as high as 95 percent. See discussion beginning on page 15.59.)

[3] 7 U.S.C.A. § 1988(f) (West 1988); 7 C.F.R. § 1980.6(a)(11).



The guaranteed loan regulations are different from the direct loan regulations. In many situations, the guaranteed loan regulations are less helpful to farmers than the regulations for regular (direct) loans. For example, the interest rates for guaranteed loans are generally higher, the appeals process for guaranteed loans is much more difficult to use, and it is more difficult to qualify for the guaranteed loan debt restructuring program.

☐ Use of Guaranteed Loans Is Increasing

FmHA is shifting more and more of its money from its regular (direct) loan programs to its guaranteed loan programs. Therefore, the guaranteed loan program is becoming increasingly important to farmers.

☐ Farmers Report Many Violations of the Guaranteed Loan Laws

Farmers report that their basic rights in the guaranteed loan program are often violated. For example, most farmers who we talk to were never given their *meeting upon default*. (See discussion beginning on page 15.52.)

In the very early 1980s, most farmers and many county-level FmHA employees were not aware of farmers' basic rights in FmHA's *direct* loan program. After years of litigation, education efforts, lobbying, and political pressure by farm advocacy groups, things have changed drastically. Unfortunately, though, the changes have not spilled over into the guaranteed loan program. The level of awareness of farmers' rights in the guaranteed loan program today seems to be as bad as it was in the direct loan program in 1980.

Therefore, it is very important for farmers and farm advocates to learn about farmers' rights in guaranteed loan programs and to work to make sure that those rights are honored.

What's New With Guaranteed Loans

☐ The Most Important New Changes

Following is a brief list of important changes in the guaranteed loan program. The changes come from the Agricultural Credit Act of 1987[4] (the "Act") and from the January 1989 regulations.[5]

A. Write-Downs

Under the **old** regulations, lenders did not write down farmers' loans because they could not get FmHA to pay their losses for write-downs. Now, under the **new** Act, FmHA **must pay** the lender for losses when the lender chooses to write down a guaranteed loan with FmHA approval. FmHA **must approve** a write-down if your cash flow meets a certain formula. (See discussion beginning on page 15.49.)

If your loan is written down, you will be required to enter into a shared appreciation agreement. (See discussion beginning on page 15.44.)

B. Payment of Estimated Loss in Bankruptcy

The new regulations make it possible for banks to get payments of *estimated* losses while farmers' bankruptcy cases are pending. Hopefully, this change will increase banks' willingness to make guaranteed loans.[6]

C. Late Regulations

The Act required FmHA to have new guaranteed loan regulations in effect by June 4, 1988.[7] However, FmHA did not issue these regulations until January 13, 1989—over seven months late. During those seven months, FmHA continued to approve liquidations and foreclosures under the old regulations. If your loan was liquidated or your mortgage was foreclosed during that period, your rights may have been violated. See a lawyer.

D. No Notice

The new regulations create some great new options for farmers, but the regulations do not require FmHA to give notice of those options to anybody! Your banker probably does not know that he or she may be able to write down your loan and get paid for the loss. **EDUCATE YOUR BANKER!** Explain the program to your banker, and bring a copy of this article to him or her.

[4] Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 1568 (1988) (codified at 7 U.S.C. §§ 2005, 1999, 1983b, and 1989).

[5] 54 Fed. Reg. 1534-1600 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subparts A and B).

[6] See 7 U.S.C.A. § 2005(a)(1) (West 1988); 54 Fed. Reg. 1570-71 (Jan. 13, 1989) (to be codified at 7 C.F.R. 1980.144); prefatory comments, 54 Fed. Reg. 1535, 1543 (Jan. 13, 1989).

[7] 7 U.S.C.A. § 1989, note (West 1988).

E. Ten-Percent Reserve

To meet the definition of "positive cash flow" in the guaranteed loan program, in some cases your plan must show a 10-percent reserve. (See discussion beginning on page 15.27.)

F. Sixty-Day Foreclosure Freeze

When "liquidation is imminent," the lender must consider you for an interest rate buydown and must ask FmHA to determine your eligibility for a buydown. The lender may not initiate any foreclosure action on your loan until 60 days after a decision is made about your eligibility for a buydown. (FmHA takes the position that this only applies to new loans. See discussion beginning on page 15.34.)

G. Demonstration Project

There is a new "demonstration project" that encourages farmers to use FmHA guaranteed loans to buy land from the Farm Credit System (FCS) inventory. (See discussion beginning on page 15.58.)

☐ How the New Changes Apply to Old Loans

FmHA may try to apply different rules to you, depending on when you got your loan guarantee.

The new regulations *should* apply to you even if you got your guarantee before the new regulations were issued or before the Agricultural Credit Act of 1987 was passed. There are two arguments that support this position. First, the language of the regulations seems to say that the new rules apply to **all** guaranteed loans, without regard to when you got the loan. Second, in general the lender's agreement incorporates the current regulations and all future regulations that are not inconsistent with the lender's agreement.[8]

Despite those arguments, though, FmHA may not apply the new regulations to old loans. FmHA may take the position that only new loans get the benefit of the new regulations. (They may define "new" as loan guarantees issued after the passage of the Agricultural Credit Act[9] *or* as loan guarantees issued after the new regulations became effective.[10]) FmHA has already taken the position that the lender can choose between applying the old regulations or the new regulations for old loans[11] regarding all **liquidation** issues, including mandatory interest rate buydown consideration and the 60-day foreclosure freeze.[12] (By the terms of the statute, the 60-day foreclosure freeze only applies to new loans. See the discussion on page 15.34.) If you are hurt because the lender serviced your loan under old regulations, see a lawyer.[13]

---

[8] 54 Fed. Reg. 1553 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B, "Lender's Agreement," § XVIII.)

[9] The effective date of the Act was January 6, 1988.

[10] The effective date of the regulations was January 13, 1989.

[11] FmHA AN No. 1911 (1980) (Apr. 25, 1989) says, "If a lender has made a loan or line of credit guaranteed by FmHA under previous regulations and Lender's Agreement(s), and the lender wishes to initiate liquidation action, the lender may do so under the provision of the previous regulations or under the provisions of the current regulations, at the lender's option.... the Agricultural Credit Act of 1987 requires that all guarantees issued after January 6, 1988, contain a provision that foreclosure action cannot be initiated until 60 days after a determination is made as to the borrower's eligibility for an interest rate buydown. This provision was added to FmHA Instructions 1980-B and the Lender's Agreements on March 11, 1988. Loans for which guarantees were issued prior to January 6, 1988, *are not* subject to this provision." (Emphasis in original.)

Getting a Guaranteed Loan

☐ Purposes for Which You Can Get a Guaranteed Loan

A. Types of Loans

Under the old regulations, FmHA could guarantee *five* types of loans. Under the new regulations, FmHA can only guarantee *three* types of loans:[14] loans for *operating* (OL), *farm ownership* (FO), and *soil and water* (SW) purposes.

- Guaranteed **operating** purposes include but are not limited to: the purchase of machinery, equipment, and livestock; the payment of annual operating expenses and family living expenses; and the refinancing of operating debt.[15]
- Guaranteed **farm ownership** purposes include but are not limited to: purchase or enlargement of a farm; construction, purchase, or improvement of farm buildings or facilities; land and water development; and pollution control and energy saving measures.[16]
- Guaranteed **soil and water** purposes include but are not limited to: land and water development, use, and conservation; energy-saving measures related to soil conservation; paying the costs of meeting governmental requirements regarding pollution control and abatement; acquiring sources of water; refinancing certain debts; certain land purchases related to water or drainage facilities; and payment of certain costs related to participation in ASCS or SCS programs.[17]

---

[12] See 7 C.F.R. § 1980.64(b) and FmHA National AN No. 1911 (1980) (Apr. 25, 1989; expires Sept. 30, 1989).

[13] FmHA has a *statutory* basis for taking that position regarding the 60-day foreclosure freeze. 7 U.S.C.A. § 1999(g) (West 1988). But its *regulations* regarding the freeze seem to apply to new and old loans. 54 Fed. Reg. 1592 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § II). None of the other new statutory provisions contain any basis for treating new loans differently from old loans.

[14] 54 Fed. Reg. 1559 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.101(a)). *New* recreation loans (RL) and emergency loans (EM) will not be guaranteed by FmHA. *Existing* RL and EM guaranteed loans will continue to be serviced according to the guaranteed loan regulations.

[15] See 54 Fed. Reg. 1574 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(c)) for a complete list of authorized purposes.

[16] See 54 Fed. Reg. 1576 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(c)) for a complete list of authorized purposes.

[17] See 54 Fed. Reg. 1580 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(c)) for a complete list of authorized purposes.

Guaranteed **lines of credit** are available for operating purposes only.[18] A line of credit is a fund from which you can draw money for three years without applying for a new loan.[19]

B. Refinancing With Guaranteed Loans

There are at least four ways in which you might want to use guaranteed loans as part of a refinancing deal:

- Use an FmHA *guaranteed* loan to buy out an FmHA *direct* loan (for example, if you must graduate to another lender) (see discussion beginning on page 12.3);
- Use an FmHA *guaranteed* loan to finance a *net recovery value buyout*[20] of an FmHA direct loan;
- Use an FmHA *guaranteed* loan to buy out a *loan that is held by a private bank*, a Farm Credit System lender, or the Federal Deposit Insurance Corporation (FDIC); and
- Use an FmHA *direct* loan to buy out an FmHA *guaranteed* loan.

Each of these possibilities is discussed below.

1. Using Guaranteed Loans to Buy Out Direct Loans

Generally, you can use FmHA guaranteed loans to buy out FmHA direct loans if you meet certain rules. The details are explained below. Note that farmers who have FmHA direct loans are supposed to be given **preference** when they apply for guaranteed loans.[21] (See discussion beginning on page 15.24.)

a. For Operating (OL) Purposes[22]

The rules for guaranteed operating *loans* are different from the rules for guaranteed *lines of credit*.

You can use a guaranteed operating **loan** to refinance debt that you incurred for any authorized operating purpose (see page 15.9). The regulations specifically say that this includes the refinancing of FmHA direct loans.[23] Of course, you must meet all of the eligibility and approval rules for a guaranteed OL loan. (See page 15.23.)

[18] 54 Fed. Reg. 1559 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.101(e)(2)); 54 Fed. Reg. 1574 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(c)(2)).

[19] 54 Fed. Reg. 1574 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(c)(2)). Lines of credit are available for farm, forestry, recreation, and nonfarm enterprises for the following purposes when they are essential to your operation: (1) paying annual operating expenses, which may include buying feeder animals; (2) paying debts that you incurred for current annual operating expenses before you got the guaranteed loan. (Carry-over debts from previous crop years will not be refinanced in this program.) All advances must be repaid within seven years of the date of your line of credit agreement. 54 Fed. Reg. 1575 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(f)(1)).

[20] In FmHA's direct loan program, a farmer who cannot cash flow a restructuring plan is offered a chance to buy out the loan at the net recovery value. (See discussion beginning on page 10.18.)

[21] It is unclear whether this provision would apply if you used the guaranteed loan for a buyout and then, after the buyout, you would no longer have any FmHA direct loans. See footnote 77 on page 15.24.

[22] See page 15.9 for a description of operating purposes.

[23] 54 Fed. Reg. 1574 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(c)(1)(iv)).

If you will still have an FmHA direct OL after the refinancing, you must also meet the following rules:

- Your outstanding direct and guaranteed OL principal balance at loan closing may not exceed $400,000;[24] and
- The direct OL security must be separate and identifiable from the guaranteed OL security.[25]

You can use a guaranteed operating **line of credit** to pay debts that you incurred for *current* annual operating expenses. You cannot use a guaranteed operating line of credit to refinance carry-over debt from previous crop years.[26] Therefore, you could not use a guaranteed operating *line of credit* to refinance an FmHA direct loan unless the direct loan was incurred for current operating expenses.

Of course, to get a guaranteed line of credit, you must meet all of the eligibility rules for that program. (See page 15.23.)

b. For Farm Ownership (FO) Purposes[27]

The regulations say that you can use a guaranteed farm ownership loan to refinance debt if:[28]

- Your present creditors will not give you credit at rates and terms that you can meet;
- The lender will verify the need to "refinance all secured debts and major unsecured debts ... [and will verify the] unpaid balance on the debts to be refinanced."

If you have an **EE loan** (direct or guaranteed), your total outstanding principal indebtedness to FmHA and/or the guaranteed lender(s) for the EE and any SW, RL, OL, and FO loans combined may not exceed $650,000.[29]

If you meet the rules explained above, you should be able to use a guaranteed FO loan to refinance an FmHA direct loan. Of course, the loan would have to be for guaranteed FO purposes (see page 15.9), and you would have to meet all of the eligibility rules for guaranteed FO loans (see page 15.23).

---

[24] 53 Fed. Reg. 35690 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1941.29(b)(1)); 54 Fed. Reg. 1574 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(d)(1)). For entity applicants (such as partnerships and corporations), see 53 Fed. Reg. 35690 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1941.29(b)(2)).

[25] 53 Fed. Reg. 35690 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1941.29(b)(3)). Different lien positions on real estate are considered separate and identifiable collateral. 54 Fed. Reg. 1561 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.108(d)(2)(ii)).

[26] 54 Fed. Reg. 1574 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(c)(2)(ii)).

[27] See page 15.9 for a description of farm ownership purposes.

[28] 54 Fed. Reg. 1576 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(c)(4)).

[29] 53 Fed. Reg. 35701-02 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1943.29(c)); 54 Fed. Reg. 1561 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.108(d)(1)).

c. For Soil and Water (SW) Purposes[30]

The regulations say that you can use a guaranteed soil and water (SW) loan to refinance debt if:[31]

- The debt was incurred for authorized guaranteed SW purposes (see page 15.9); and
- All development or repair work conforms to FmHA standards or those standards will be met with the guaranteed loan; and
- Your present creditors will not furnish credit at rates and terms that you can meet; and
- The lender will verify the "need to refinance all secured and major unsecured debts ... [and will verify the] unpaid balance on the debts to be refinanced."

If you have or are applying for an **EE loan** (direct or guaranteed), your total outstanding principal indebtedness to FmHA and/or guaranteed lenders for your EE, FO, RL, OL, and SW loans combined may not exceed $650,000.[32]

If you meet the rules explained above, you should be able to use a guaranteed SW loan to refinance an FmHA direct loan. Of course, you will have to meet all of the eligibility rules for a guaranteed SW loan. (See page 15.23.)

2. Using Guaranteed Loans to Finance Net Recovery Value Buyouts[33]

Technically, the regulations allow you to use an FmHA guaranteed loan to finance a net recovery value buyout of an FmHA direct loan if you meet all of the eligibility rules explained beginning on page 15.10 ("Using Guaranteed Loans to Buy Out Direct Loans"). The regulations say that FmHA will not provide "credit" for a net recovery value buyout, but in a guaranteed loan it is arguably the lender, not FmHA, who is providing the "credit."[34]

The fact that you did not fully pay back your direct loan should not necessarily be held against you. The eligibility rules for a guaranteed loan require that you show "reasonable assurance of a positive cash flow projection,[35] and ... sufficient collateral and equity."[36] The fact that you took a net recovery value buyout should not necessarily hurt your attempts to meet the eligibility rules. The rules specifically say that:

---

[30] See page 15.9 for a description of soil and water purposes.

[31] 54 Fed. Reg. 1580 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(c)(4)).

[32] 53 Fed. Reg. 35712 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1943.79(b)); 54 Fed. Reg. 1561 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.108(d)(1)).

[33] Net recovery value buyouts are explained beginning on page 10.18.

[34] 53 Fed. Reg. 35729 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1951.909(h)(3)(iii)).

[35] See discussion beginning on page 15.27 for an explanation of positive cash flow.

[36] 54 Fed. Reg. 1564 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.114). In addition, you must meet the eligibility requirements for the particular type of loan in question.

> "Past record of debt repayment will not be cause for a determination that the applicant is not eligible if an honest attempt has been made to meet the obligation."[37]

As a practical matter, farmers report that it is almost impossible to get a guaranteed loan to finance a net recovery value buyout.

3. Using Guaranteed Loans to Buy Out Other Types of Loans

The rules explained in part 1 beginning on page 15.10 ("Using Guaranteed Loans to Buy Out Direct Loans") are general rules about using FmHA guaranteed loans to refinance debt. If you meet those rules, you should be able to use an FmHA guaranteed loan to buy out a loan that is held by a private bank, a Farm Credit System lender, or the Federal Deposit Insurance Corporation (FDIC).

4. Using FmHA Direct Loans to Buy Out Guaranteed Loans

Sometimes you can use an FmHA direct loan to buy out an FmHA guaranteed loan. The rules are different, depending on the purpose of the loan.

a. For Operating (OL) Purposes[38]

A direct OL can be used to buy out a guaranteed OL if you meet the following conditions:

- You need to refinance because of circumstances beyond your control;[39] and
- Refinancing is in the best interests of you and the government;[40] and
- The guaranteed OL must be completely paid off at the time the direct OL is closed.[41]
- If you have an **EE loan** (direct or guaranteed), your total outstanding principal indebtedness to FmHA and/or FmHA guaranteed lenders for your EE loan and any FO, SW, RL, and/or OL loans will not exceed $650,000.[42]

Of course, you must also meet the direct OL eligibility rules. (See discussion beginning on page 7.15.)

[37] *For OL loans:* 54 Fed. Reg. 1573 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(b)(1)(iv)). *For FO loans:* 54 Fed. Reg. 1576 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(b)). *For SW loans:* 54 Fed. Reg. 1579 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(b)(1)(iii)).

[38] See page 15.9.

[39] 53 Fed. Reg. 35690 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1941.29(c)(1)).

[40] 53 Fed. Reg. 35690 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1941.29(c)(2)).

[41] 53 Fed. Reg. 35690 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1941.29(c)(3)).

[42] 53 Fed. Reg. 35690 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1941.29(d)).

b. For Farm Ownership (FO) Purposes[43]

The regulations do not discuss the use of direct FO loans to buy out guaranteed FO loans. Therefore, it seems that you can do it if you can meet the regular FO eligibility and approval rules. (See discussion beginning on page 7.15.)

If you will still have an outstanding guaranteed FO, SW, or RL loan after the buyout:

- Your total direct and guaranteed FO, SW, and RL principal balance, including the new loan, must not exceed $300,000 at loan closing;[44] and
- Different lien positions on your real estate will be considered separate and identifiable collateral.[45]

c. For Soil and Water (SW) Purposes[46]

The regulations do not discuss the use of direct SW loans to buy out guaranteed SW loans. Therefore, it seems that you can do it if you can meet the regular SW eligibility and approval rules. (See discussion beginning on page 7.15.)

If you will still have an outstanding guaranteed FO, SW, or RL loan after the buyout:

- Your total direct and guaranteed FO, SW, and RL principal balance, including the new loan, must not exceed $300,000 at the loan closing;[47]
- Different lien positions on your real estate will be considered separate and identifiable collateral.[48]

☐ Terms for Guaranteed Loans

The following chart explains:

- The maximum loan amount,
- The maximum payback period, and
- The interest rate

that you can get from different kinds of guaranteed loans.

In some cases, the interest rates on the chart can be lowered if you use the interest rate buydown program. See the discussion beginning on page 15.30.

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[43] See page 15.9.

[44] 53 Fed. Reg. 35701 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1943.29(b)(1)). For entity applicants, see 53 Fed. Reg. 35701 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1943.29(b)(2)).

[45] 53 Fed. Reg. 35701 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1943.29(b)(3)).

[46] See page 15.9.

[47] 53 Fed. Reg. 35712 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1943.79(c)(1)).

[48] 53 Fed. Reg. 35712 (Sept. 14, 1988) (to be codified at 7 C.F.R. § 1943.79(c)(2)).

	Guaranteed Loan Terms		
	Maximum Loan Amount	**Interest Rate**	**Maximum Payback Period**
Guaranteed Operating Loans (GOL) 54 Fed. Reg. 1573-75 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175)	Total outstanding principal balance of all direct and guaranteed OL loans not to exceed $400,000 54 Fed. Reg. 1574 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(d)(1))	To be agreed upon by borrower and lender. Not to exceed the rate the lender charges its average farm customers.* Rate can be variable or fixed. 54 Fed. Reg. 1574 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(e))	***Regular GOL:*** Generally 7 years, but can include balloon to be paid over an additional 7 to 15 years. 54 Fed. Reg. 1575 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(f)) ***Line of Credit GOL:*** 7 years from the date of the contract of guarantee. 54 Fed. Reg.1575 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(f))
Guaranteed Farm Ownership Loans (GFO) 54 Fed. Reg. 1575-78 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180)	Total outstanding principal balance of all FO, SW, and RL loans (guaranteed and direct) not to exceed the lesser of $300,000 or the market value of the security property. 54 Fed. Reg. 1576 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(d)(1))	Same as above. 54 Fed. Reg. 1577 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(e)(1))	40 years 54 Fed. Reg. 1577 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(e))
Guaranteed Soil and Water Loans (GSW) 54 Fed. Reg. 1578-82 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185)	Same as above. 54 Fed. Reg. 1580 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(d)(1))	Same as above. 54 Fed. Reg. 1580 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(e)(1))	Same as above. 54 Fed. Reg. 1580 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(e))

* "Average farm customers" do not include high-risk farmers. *See* 7 C.F.R. § 1980.175(e). The provision in the old regulations that allowed the lender to charge 1 percent above this rate has been eliminated. *See* prefatory comments at 54 Fed. Reg. 1544 (Jan. 13, 1989).

Guaranteed Loan Terms

FmHA no longer **makes** guaranteed RL or EM loans, but it still **services** those loans. These programs were deleted from the January 1, 1989 regulations. The following terms are from the 1988 regulations. This information is included here because it may be helpful to you when you try to obtain loan servicing on guaranteed RL or EM loans.

	Maximum Loan Amount	**Interest Rate**	**Maximum Payback Period**
Guaranteed Recreation Loans (GRL) 7 C.F.R. § 1980.190	Total outstanding principal balance of all FO, SW, and RL loans (guaranteed and direct) not to exceed the lesser of $300,000 or the market value of the security property. 7 C.F.R. § 1980.190(e)(1)	Under the 1988 regulations, allowed 1 percent above the rate charged to the average farm customer. 7 C.F.R. § 1980.190(f)(2)	40 years 7 C.F.R. § 1980.190(f)(1)
Guaranteed Emergency Loans (EM) 7 C.F.R. § 1980.170	No maximum (except: if the disaster happened on or after 7/1/76 and before 10/1/78 and the actual loss loan was approved by FmHA on or after 10/1/78, the maximum is $250,000). 7 C.F.R. §§ 1980.170(e)(1)(i) and 1980.170(a)	***Actual Loss:*** If the disaster happened on or after 10/1/78, 5 percent interest. (If the disaster happened on or after 7/1/76 and before 10/1/78 and the loan was approved by FmHA on or after 10/1/78, 3 percent interest.) ***Major Adjustment or Annual Operating:*** Prevailing market rate for similar loans, as determined by FmHA. 7 C.F.R. § 1980.170(e)(1)(iii)	***Operating Purposes:*** Generally 7 years, but up to 20 years if needs justify it. ***Real Estate Purposes:*** 40 years 7 C.F.R. § 1980.170(e)(3)

☐ Applying for a Guaranteed Loan

How to Start. You should start the process by going to the bank (or other lender) and asking to apply for an FmHA guaranteed loan. The lender will probably have its own procedure for handling the FmHA application. Your lender may not want to apply for a guaranteed loan at first; you may have to encourage your lender, and offer to help him or her with the application. The lender usually does most of the paperwork because the application process is very complicated.[49]

The Approved Lender Program. Any lender can apply for a guaranteed loan for you. But the process might go smoother if you find a lender that is in FmHA's approved lender program.[50] You can find out the names of the approved lenders in your state by writing a letter to FmHA.

Certified Mail Your Address
Return Receipt Requested Date

Bob Jones
FmHA County Supervisor
Address of FmHA Office

Dear Mr. Jones:

Please send me a list of all of the "approved lenders" for guaranteed loans in this state. The regulations say that you must make this list available to me upon request. 54 Fed. Reg. 1582 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980, Subpart B, Exhibit A, § I.C.)

Sincerely,

Joe Smith

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[49] The application process is explained at 54 Fed. Reg. 1562-65 (Jan. 13, 1989) (to be codified at 7 C.F.R. §§ 1980.113-1980.115).

[50] 54 Fed. Reg. 1582-92 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit A).

A. There Are Two Steps

1. The Preliminary Application

The preliminary application can be used to learn whether you are **eligible** for the loan.

Filling out a preliminary application is less work than filling out a complete application. You and the lender can use the preliminary application to learn whether you are eligible for the loan and whether FmHA has the authority and ability to make the loan.[51] The main reason to use a preliminary application is that it allows you to get an answer about your eligibility **before** you do most of the paperwork required by the complete loan application.

The following information is needed for the preliminary application:[52]

- A completed Form FmHA 410-1, "Application for FmHA Services" (see Appendix D);[53]
- Proof of your off-farm employment, if any;
- Information about your credit history;
- If you are applying for a line of credit, an explanation of your proposed agreement.

If your farming operation is a cooperative, corporation, partnership, or joint operation, you must submit additional information to document the financial situation of the other people and entities that have an interest in your operation.[54]

The lender will probably do most of the work to gather information and submit the application to FmHA; you will have to cooperate by giving the information to the lender.

2. The Complete Application

The complete application requires all of the items required on the preliminary application, plus a lot of additional information.[55] The additional information includes:[56]

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[51] The preliminary application is optional; you and the lender could choose to start with the complete application instead. All of the information required in the preliminary application is required in the complete application as well. 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(1)).

[52] 54 Fed. Reg. 1562 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)).

[53] If the lender is a member of FmHA's "Approved Lender Program," only parts of the application need to be completed. 54 Fed. Reg. 1562 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(a)(1)).

[54] For details, see 54 Fed. Reg. 1562 (Jan. 13, 1989) (to be codified at 7 C.F.R. §§ 1980.113(a)(4) and 1980.113(b)).

[55] 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)); see also 7 C.F.R. Part 1980, Subpart B, Exhibit C. This exhibit, entitled "Application Processing for Guaranteed Loans," can be obtained by writing to FmHA.

[56] The following list of information is not complete. It lists only those items that are most likely to require the farmer to submit information to the lender. See 54 Fed. Reg. 1563-64 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)) for a complete list.

a. Details about any leases or contracts that relate to your operation.

b. Details about your proposed loan agreement, including:

  - Any improved management practices you plan to use.
  - Requirements for recordkeeping and financial reporting.
  - A list of the security for the loan.
  - Your maximum debt-to-asset ratio.
  - The interest rate.
  - Your plan for repaying your line of credit.

c. Financial information about your operation for the upcoming year and for the past five years. This should include your production history and your projected production, income, and expenses.[57] (See the discussion of **positive cash flow** beginning on page 15.27 for a detailed explanation of guaranteed loan cash flow requirements.)

d. Appraisals of security property.[58] (FmHA's guaranteed loan appraisal regulations are explained beginning on page 15.29.)

Look in the regulations at § 1980.113(d) for a full, detailed list of everything required for the application.

B. FmHA's Deadlines

If you and the lender filed a **preliminary** application, FmHA must:

- Notify you and the lender in writing within *five calendar days* after they make their decision if they decide that you *are not eligible;*[59]
- Notify you and the lender in writing within *ten calendar days* after they received your preliminary application if they decide that you *are eligible.*[60] In that case, FmHA will request that the lender submit a complete application.

If you and the lender filed a **complete** application, FmHA must decide about it within **45 days** after FmHA received the completed application. FmHA must promptly notify you of its decision.[61] The following chart summarizes these deadlines.

[57] 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(8)) lists details about how this information must be developed.

[58] 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(9)).

[59] 54 Fed. Reg. 1562 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(c)). The notice must also explain the reasons for the denial, and it must explain your appeal rights.

[60] 54 Fed. Reg. 1562 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(c)).

[61] 54 Fed. Reg. 1564 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.115, "Administrative" provision, § B(1)); see also prefatory comments at 54 Fed. Reg. 1539 (Jan. 13, 1989).

FmHA's Deadlines for Decisions About *Preliminary* and *Complete* Applications

	Preliminary Application	**Complete Application**
If You Are Eligible	Within 10 days after FmHA received your preliminary application	Within 45 days after FmHA recieved your completed application
If You Are Not Eligible	Within 5 days after they make their decision	Within 45 days after FmHA received your completed application

(See the next section for an explanation of the *county committee's* deadlines and the *supervisor's* deadlines.)

☐ How FmHA Decides Whether to Guarantee Your Loan

A. The Process

The process is similar to the process for direct loans. First, the *county committee certifies* that you are eligible, and then the *county supervisor approves* the loan.[62] The eligibility and approval rules are explained in detail in the next two sections. The following chart gives a brief summary of those rules.

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[62] 54 Fed. Reg. 1564-65 (Jan. 13, 1989) (to be codified at 7 C.F.R. §§ 1980.114 and 1980.115); see also prefatory comments at 54 Fed. Reg. 1539 (Jan. 13, 1989). After the county committee certifies that you are eligible and the county supervisor approves the loan, the county supervisor should fill out a form that notes any special conditions of the approval. (For guaranteed loans, it is Form FmHA 449-14; for guaranteed lines of credit, it is Form FmHA 1980-15.) "Special conditions" might include requirements for security, improved management practices, and specific types of financial reports. 54 Fed. Reg. 1564 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.115, Administrative, paragraph A). If you cannot meet the conditions, you can propose alternatives. The county supervisor must accept or reject your alternatives within ten days. If they are rejected, you must be given notice of the reasons and of your right to appeal. 54 Fed. Reg. 1565 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.116).

Guaranteed Loan Eligibility and Approval Rules

County Committee ELIGIBILITY	County Supervisor APPROVAL
• Citizenship • Legal Capacity • Character and industry • Honesty • Unable to get sufficient credit elsewhere • Education, training, and job experience (OL and FO only) • Owner and/or operator of proper-sized farm as required in specific loan program • If tenant, a satisfactory written lease (SW only)	• Authorized loan purpose • Positive cash flow projection • Collateral and equity

After FmHA receives your **complete** application, the *county committee* should make its *eligibility* decision within:[63]

- *14 calendar days* if the lender is part of the Approved Lender Program (ALP); or
- *30 calender days* if the lender is not part of the ALP

Then the *county supervisor* should make his or her *approval* decision within:

- *14 working days* of county committee certification, if possible, for lenders who are part of the ALP[64]
- *45 calender days* from the date FmHA received the complete application if the lender is not part of the ALP[65]

These rules are summarized in the following chart.

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[63] 54 Fed. Reg. 1564 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.115).

[64] 54 Fed. Reg. 1565 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.115, Administrative, § B.5).

[65] See page 15.17 for an explanation of the ALP.

	FmHA's Deadlines for *Eligibility* and *Approval* Decisions	
	Lender Is Part of ALP	**Lender Is Not Part of ALP**
County Committee ELIGIBILITY	14 calendar days after complete application is submitted	30 calendar days after complete application is submitted
County Supervisor APPROVAL	14 working days after county committee certification (if possible)	45 calendar days after complete application is submitted

B. Eligibility Rules

The county committee decides whether you are eligible for a guaranteed loan. This section explains what the committee is allowed to consider in its decision about your eligibility.

1. Basic Eligibility Rules

To be eligible as an individual[66] for a guaranteed operating loan (OL), guaranteed farm ownership loan (FO), or guaranteed soil and water loan (SW), you must:[67]

- Be a *citizen*.[68]
- Have the *legal capacity* to incur the loan obligations (usually this means that you are old enough to sign a contract and you understand what you are doing).
- Have the *character* (emphasizing credit history, past record of debt repayment and reliability) and *industry* to carry out the proposed operation. The regulations specifically say that:

> "Past record of debt repayment will not be cause for a determination that the applicant is not eligible if an honest attempt has been made to meet the obligation."[69]

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[66] For a cooperative, corporation, partnership, or joint operation, see 54 Fed. Reg. 1573-75 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(b)(2)) *for OL loans;* 54 Fed. Reg. 1576 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(b) and (b)(2)) *for FO loans;* 54 Fed. Reg. 1579 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(b)(2)) *for SW loans.*

[67] These eligibility rules are located at: 54 Fed. Reg. 1573 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(b)(1)) *for OL loans;* 54 Fed. Reg. 1576 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(b)) *for FO loans;* 54 Fed. Reg. 1579 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(b)) *for SW loans.*

[68] For details, see the regulations listed in footnote 85 on page 7.17.

[69] *For OL and FO loans:* 54 Fed. Reg. 1573 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(b)(1)(iv)). *For SW loans:* 54 Fed. Reg. 1579 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(b)(1)(iii)).

- *Honestly* try to carry out the terms and conditions of the loan.
- *Be unable to obtain sufficient credit* without a guarantee.[70]

2. Eligibility Rules For Specific Programs

In *addition* to the five eligibility rules listed above, you must meet the following rules for the following specific loan programs:

a. For the guaranteed **operating loan** program, you must:

- Meet the five rules explained in part 1 on pages 15.22–15.23.
- Have sufficient education, training, or job experience to assure reasonable prospects of success in the proposed operation. (The regulations say that you must have had education, training, or experience in one of the last five years.)[71]
- Be an owner-operator or tenant-operator of not larger than a family farm after the loan is closed.[72]

b. For the guaranteed **farm ownership** program, you must:

- Meet the five rules explained in part 1 on pages 15.22–15.23.
- Have sufficient education, training, or job experience to assure reasonable prospects of success in the proposed operation. (The regulations say that you must have had education, training, or experience in one of the last five years.)[73]
- Be the owner-operator of not larger than a family farm after the loan is closed.[74]

c. For the guaranteed **soil and water** program, you must:

- Meet the five rules explained in part 1 on pages 15.22–15.23.
- Be the owner or operator of a farm after the loan is closed;[75]
- If you are a tenant, you must have a "satisfactory written lease" that will enable you to receive reasonable returns on the improvements that you make with the loan.[76]

The eligibility rules are summarized in the following chart.

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[70] Details are located at 54 Fed. Reg. 1573 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(b)(1)(vi)) *for OL and FO loans;* and at 54 Fed. Reg. 1579 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(b)(1)(v)) *for SW loans.*

[71] 54 Fed. Reg. 1573 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(b)(1)(iii)).

[72] 54 Fed. Reg. 1573 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(b)(1)(vii)).

[73] 54 Fed. Reg. 1576 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(b)).

[74] 54 Fed. Reg. 1576 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(b)(2)).

[75] 54 Fed. Reg. 1579 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(b)(1)(vi)).

[76] In addition, "the lease should provide for compensating [you] ... for any unexhausted value of the improvements upon termination of the lease." 54 Fed. Reg. 1579 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(b)(1)(vii)).

ELIGIBILITY
What the county committee can consider in its decision about your eligibility for a guaranteed loan

OL Loans	FO Loans	SW Loans
• Are you a *citizen?* • Do you have *legal capacity* to incur the obligation? • Do you have the *character and industry* to carry out the proposed operation? • Will you *honestly try* to carry out the loan? • Are you *unable to get sufficient credit* without a guarantee? • Do you have sufficient *education, training, or job experience?* • Will you be the *owner-operator* or *tenant-operator* of a not-larger-than-family-sized farm after the loan is closed?	• Are you a *citizen?* • Do you have *legal capacity* to incur the obligation? • Do you have the *character and industry* to carry out the proposed operation? • Will you *honestly try* to carry out the loan? • Are you *unable to get sufficient credit* without a guarantee? • Do you have sufficient *education, training, or job experience?* • Will you be the *owner-operator* or *tenant-operator* of a not-larger-than-family-sized farm after the loan is closed?	• Are you a *citizen?* • Do you have *legal capacity* to incur the obligation? • Do you have the *character and industry* to carry out the proposed operation? • Will you *honestly try* to carry out the loan? • Are you *unable to get sufficient credit* without a guarantee? • Will you be the *owner or operator* of a farm after the loan is closed? • If you are a *tenant,* do you have a satisfactory written *lease?*

3. Farmers Who Have FmHA Direct Loans Get Preference

If FmHA does not have enough money to make guarantees for all eligible applicants, farmers who have FmHA direct loans should be given preference over farmers who do not have direct loans.[77]

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[77] The language is: "An Application on hand from an FmHA insured loan borrower will be given preference over one from an applicant who does not have an FmHA insured loan." 54 Fed. Reg. 1561 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.108(b)(2)). Preferences are also given to farmers who (1) are veterans; (2) have a dependent family; (3) own necessary livestock and farm implements; (4) are able to make down payments. 54 Fed. Reg. 1561 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.108(b)).

C. Approval Rules

1. In General

If the county committee determines that you are **eligible** for the guaranteed loan, your application should be transferred to the county supervisor.[78] The supervisor must decide whether to **approve** your loan. The supervisor can consider three issues:[79]

- Whether the loan is for authorized purposes; and
- Whether there is reasonable assurance of a positive cash flow projection; and
- Whether there is sufficient collateral and equity.

The approval rules are summarized in the following chart.

APPROVAL

What the county supervisor can consider in deciding whether to approve your guaranteed loan

- Is the loan for an *authorized purpose?*
- Is there a reasonable assurance of a *positive cash flow projection?*
- Is there sufficient *collateral and equity?*

To learn more about the *authorized purposes* for the different kinds of loans, see the discussion beginning on page 15.9. To learn more about *positive cash* flow in the guaranteed loan program, see the discussion beginning on page 15.27. To learn more about what is *sufficient collateral* for the different types of loans, see the regulations regarding security for each loan program.[80]

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[78] Prefatory comments, 54 Fed. Reg. 1539 (Jan. 13, 1989).

[79] 54 Fed. Reg. 1564 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.114).

[80] 54 Fed. Reg. 1575 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.175(g) and (h)) for OL loans; 54 Fed. Reg. 1577 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(f) and (g)) for PO loans; 54 Fed. Reg. 1580-82 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.185(f) and (g)) for SW loans.

2. Special Rules for Farmers Affected by 1988 Disasters[81]

FmHA has a new program that may help you if you had severe production losses caused by a 1988 disaster. The program is required by the Disaster Assistance Act of 1988.[82] All loans under this program must be approved on or before September 30, 1989.

The program allows FmHA to guarantee operating loans to help you with debt payments that you cannot make because of the disaster. Specifically, these loans can be used to repay your 1988 operating debt and/or your 1988 and 1989 installments due on other farm debt. To get the loan, you must show that:

- You are eligible to receive disaster program benefits from ASCS based on production losses to any commercial crop grown for harvest in 1988; **or**
- You suffered major losses as a result of drought or related conditions, hail, flood, or other natural disasters occurring in 1988. (Major losses are losses that are large enough to qualify you for ASCS emergency livestock assistance or disaster program payments.)

Also, you must show that:[83]

- You are unable to make scheduled payments on your 1988 annual operating loans and/or 1988 and/or 1989 scheduled installments on other farm debts as a result of the disaster;
- You are *otherwise current* on your obligations to the lender making the guaranteed loan;
- Once you get the guaranteed loan, you will be *current* on all of the debts that you have refinanced;
- You must meet all of the other eligibility criteria for a guaranteed operating loan. (See discussion beginning on page 15.22.)

The regulations explain more details about the program.

The major problems with the program are the September 30, 1989 deadline and the requirement that you were current with the creditor up until the 1988 disaster.

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[81] 54 Fed. Reg. 2083-87 (Jan. 19, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit G).

[82] Disaster Assistance Act of 1988, Pub. L. No. 100-387, § 312(b).

[83] There is some question as to whether these eligibility criteria technically apply in all cases because the regulations were drafted in an awkward manner. Arguably, they apply only to § IV.A.2 loans but not to § IV.A.1 loans. See 54 Fed. Reg. 2086-87 (Jan. 19, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit G)). As a practical matter, though, all farmers will probably have to meet all of these criteria to get a loan through this program.

Positive Cash Flow For Guaranteed Loans[84]

☐ In General

The cash flow rules for *guaranteed* loans are different from the cash flow rules for *direct* loans. For guaranteed loans, the definition of positive cash flow is:[85]

> **Positive Cash Flow:** All of your anticipated cash farm and nonfarm income equals or exceeds all of your anticipated cash outflows. You must be able to show that you can: **(1)** Pay all operating expenses and all taxes that are due during the projected farm budget period; **(2)** Meet your payments on your debts, including delinquent taxes; **(3)** Pay living expenses in accordance with your essential family needs; and **(4)** Provide for a 10-percent reserve[86] in some situations. (See chart below.)

Note that the big difference between *direct* loan cash flow rules and *guaranteed* loan cash flow rules is the 10-percent reserve requirement in the guaranteed loan program. The 10-percent reserve only applies in some situations. The situations are explained in the following box.

Positive cash flow means that your income is more than your expenses. In some situations, to have a positive cash flow you must show that you have a "reserve."

To get a new FmHA guaranteed loan	10% reserve[87]
To get an FmHA guaranteed loan rescheduled, reamortized, or deferred	10% reserve[88]
To get an interest rate buydown	No reserve[89]
To get a debt write-down	No reserve[90]

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[84] 54 Fed. Reg. 1560 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.106(b)(7)); 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(8) and (9)).

[85] 54 Fed. Reg. 1560 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.106(b)(17)).

[86] The regulations do not say how the 10-percent reserve is to be calculated. They simply say "a reserve at least 10 percent in addition to the loan installments due and payable as recorded in Table K of the Farm and Home Plan or other similar plans of operation...." 54 Fed. Reg. 1560 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.106(b)(17)(iii)).

[87] 54 Fed. Reg. 1564 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.114); 54 Fed. Reg. 1560 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.106(b)(17)).

[88] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)(5)); 54 Fed. Reg. 1560 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.106(b)(17)).

[89] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § III(C)).

[90] The regulations are not quite clear on this point. It seems that you can qualify for a write-down if you can show a positive cash flow with *no reserve*, though, because: (1) The regulations discuss the write-down as something used in conjunction with the interest rate buydown program. "Positive cash flow" in that program clearly has no reserve requirement. (See footnote 117 on page 15.32.) See 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)(1)). (2) The regulations say that to obtain approval of a write-down the lender must submit to FmHA "a cash flow statement indicating the borrower can pay all necessary expenses and service all debt after the write-down." 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)(8)(i)). No mention is made of any reserve.

Generally, you project your cash flow for a one-year period. For the interest rate buydown program, though, the projection must be for a 24-month period.[91] (See discussion beginning on page 15.32.)

Your cash flow information must be based on your financial and production history from the last five years. (There are exceptions for beginning farmers and for disaster years. See the section below regarding yields.)

Information on your cash flow form must include:[92]

- Your current financial condition.
- Your projected production.
- Your projected income and expenses.
- Your loan/line of credit payment plan.

You may use FmHA's cash flow forms, such as:

- Form 431-2: Farm and Home Plan.
- Form 431-1: Long-Time Farm and Home Plan.
- Form 1924-1: Development Plan.

Or, if you prefer, you may use other similar plans of information that are acceptable to FmHA.

☐ Price Information[93]

You are **not** required to use the FmHA "price lists" that are used in the direct loan program. (See discussion beginning on page 8.10.) Instead, the regulations give the **lender** a list of the *sources of price information*. The lender is supposed to use those sources of price information to develop "operation forecast projections."[94] Here is the list of sources of price information:

- Futures market prices.[95]
- Published current market prices.
- Government loan rates, such as ASCS target prices.
- The negotiated price in any forward contract.
- Prices developed by the state land grant university for the time of crop sale.

Therefore, you should ask your lender what price information he or she would like you to use.

If you have a specialty crop and price information is not available from the sources listed above, you can use the average of the three previous years' prices.

[91] See footnote 118 on page 15.32.

[92] 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(8)).

[93] 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(8)(i)).

[94] 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(8)(i)).

[95] The regulation says, "Futures market price less the recognized basis points for the area, documented by date, location, time and degree of use." 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(8)(i)(A)).

☐ Yield Information[96]

In General. Your lender is supposed to estimate your crop yields based on your past five years' actual production records.

If you have less than a five-year history, the lender should use your actual records from whichever years you did farm.

If you are a beginning farmer, the lender should "consider" using:

- ASCS records.
- Cooperative Extension Service data.
- State averages.
- County averages.
- Any other reliable sources of information that are agreeable to the lender and to you.

Disaster Years.[97] If you have had a disaster in one (or more) of the past five years, your records from that year will show unusually low yields. You will not want to base your cash flow projection on that year because, if you do, your projected yield will be too low. If the disaster was *declared* by the President or *designated* by the Secretary of Agriculture,[98] you can substitute county average yields in place of your actual disaster year yields.[99]

☐ Appraisals[100]

In General. The regular FmHA appraisal regulations[101] do not seem to apply to guaranteed loans.[102] There are separate guaranteed loan appraisal regulations.

Guidelines. The regulations contain only one guideline for **real estate** appraisals. It is that all real estate appraisals must be based on at least two comparable sales made within two years. If the real estate was appraised by FmHA or a qualified appraiser (see discussion below) within the last 12 months, and no significant changes in the market value of real estate in the area have happened in those 12 months, you do not need a new appraisal.[103]

The regulations do not contain any guidelines for **chattel** appraisals.

Appraisal reports may be made on any form approved by the lender.[104]

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[96] 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(8)(ii)).

[97] 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(8)(ii)(D)).

[98] In the *direct* loan program, you can substitute county average yields for disaster year yields even if the disaster was not declared or designed. See page 8.9.

[99] You can only do this if your disaster year yields are *less than* the county average yields.

[100] 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(9)); 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(b)(1)(i)).

[101] 7 C.F.R. Part 1809.

[102] The guaranteed loan regulations do not cross-reference the direct loan appraisal regulations. The guaranteed loan regulations seem set up to allow the lender great discretion regarding the selection of an appraiser and an appraisal method. See the appraisal regulations cited in footnote 100 on page 15.29.

[103] 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(9)(i)(B)).

[104] If the lender wishes, the report may be made on Form FmHA 442-1, "Appraisal Report Farm Tract," and Form FmHA 440-21, "Appraisal of Chattel Property."

Appraiser Qualifications.[105] Appraisers must meet *one* of the following qualifications. (The qualifications are listed in the order of FmHA's preference.)

- Certification by a national or state appraisal society;
- If a certified appraiser is not available, the lender may use other qualified appraisers if the lender can establish that the appraiser meets the criteria for certification in a national or state appraisal society.
- The appraiser has recent, relevant, documented appraisal experience or training, or other factors clearly establish the appraiser's qualifications.

The lender must be able to prove the appraiser's qualifications to FmHA. The lender must get FmHA to agree that the appraiser is qualified before the lender uses the appraiser. If FmHA is not familiar with the appraiser, the lender must show FmHA a recent appraisal done by the appraiser.

Fees. If the appraisal is being done to determine whether you can get a debt write-down, the appraisal fee will be shared equally by the lender and FmHA.[106]

The Interest Rate Buydown Program[107]

This program reduces the interest rate on guaranteed loans in certain situations. It is for farmers who cannot demonstrate a "positive cash flow" with a guaranteed loan at the regular interest rate.

In this program, your interest rate can be reduced by *as much as 4 percent IF* that will enable you to have a positive cash flow. FmHA pays half of the cost of the reduction, and the lender pays the other half. That's why this program is sometimes called the **"2 plus 2"** program: FmHA pays for up to 2 percent of your interest, and the lender pays up to another 2 percent. The lender will reduce the interest rate by increments of 0.25 percent until the rate allows you to achieve a positive cash flow.[108] The maximum interest rate buy-down period is *three years.*[109]

The buydown program is available only if the lender will charge a **fixed interest rate** during the buydown term.[110]

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[105] 54 Fed. Reg. 1563 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.113(d)(9)(ii)).

[106] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(b)(1)(i)).

[107] As of this writing, the interest rate buydown program is scheduled to expire on September 30, 1993. (No buydown agreements may be entered into after that date.) 54 Fed. Reg. 1592 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § I).

[108] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.I).

[109] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.F). If you have had a buydown before, you can still get another if the total buydown period over the life of the loan does not exceed three years. 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit B, § V.C).

[110] See 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.H) for details about how the fixed interest rate for that period is to be calculated if the loan has a variable interest rate.

☐ When You Can Be Considered

A. You Must Be Considered for the Program at Certain Times

If you are not already involved in the buydown program, there are two situations in which your lender **must ask FmHA** to determine whether you are eligible for the program:

- When you are 30 days in default and you are unable to bring your account current within 30 days;[111] and
- When "liquidation of [your] account is imminent."[112]

The regulations are unclear as to whether the lender must give you the buydown if FmHA finds that you are eligible.[113]

Mandatory consideration for the interest rate buydown program is required by the *new* regulations. FmHA takes the position that if your loan was made under the *old* regulations (before January 13, 1989), the lender can *choose* whether to follow the old regulations or the new regulations.[114] One could make a strong argument that FmHA's position is wrong and that FmHA must now follow the new regulations in all cases. (See discussion beginning on page 15.8.)

B. You May Be Considered for the Program At Other Times

At other times, you can ask your lender to consider you for the program, but your lender is not *required* to consider you. For example, you can ask to be considered for the program:

- When you first apply for a loan; and/or
- If you are not yet in default but you need it to continue to be able to cash flow.

You cannot force your lender to participate in the buydown program.[115]

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[111] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.A.1).

[112] 54 Fed. Reg. 1592 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § II).

[113] The lender must ask FmHA to determine whether you are eligible for a buydown in two situations: (1) when you are 30 days past due and unable to bring your account current within 30 days; and (2) when liquidation is imminent. If FmHA finds that you are eligible, the *lender's* obligations may be different, depending on whether liquidation is imminent. If you are 30 days past due and FmHA finds that you are eligible, the regulations allow the lender to simply decline to use the buydown program without considering you for the program. 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.A.1). If "liquidation" is "imminent," on the other hand, your lender, "must agree" to "consider" you for an interest rate buydown. 54 Fed. Reg. 1592 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § II). The regulations never explicitly say that the lender must offer the buydown to you if FmHA finds you eligible.

[114] FmHA National AN No. 1911 (1980) (Apr. 25, 1989; expires Sept. 30, 1989). See "How the New Changes Apply to Old Loans," beginning on page 15.8.

[115] However, you can always argue that the lender has an obligation to negotiate with you in good faith. (See discussion beginning on page 15.37.)

☐ Eligibility: The Lender Must Go Through Six Steps

If your lender is interested in participating in the program, the lender can work with you to apply for it.

Step #1 *The lender determines that you cannot cash flow without a buydown.*[116]

FmHA has different definitions of "positive cash flow" in different programs. In the interest rate buydown program, positive cash flow means that you have enough farm and nonfarm cash income to cover all of your estimated farm and nonfarm cash expenses. **You do not have to show a *reserve*.** (See discussion beginning on page 15.27.)[117]

Positive Cash Flow

In the interest rate buydown program, "positive cash flow" means that you have **more** farm and nonfarm **income** than farm and nonfarm **expenses** (including debt repayment).

For the interest rate buydown program only, your cash flow projection must cover a **24-month** period.[118]

For New Loans. If you are applying for a new loan, the lender must determine whether you can cash flow without the interest rate reduction. If you can cash flow at regular interest rates, you cannot get the buydown.

For Existing Loans. If you are applying to have the interest rate reduced on an existing loan, the lender must determine whether you can cash flow with the help of loan servicing (deferrals, reamortization, rescheduling, consolidation). If you can cash flow with loan servicing, you cannot get the buydown.

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[116] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.A and B).

[117] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § III.C); see also prefatory comments at 54 Fed. Reg. 1546 (Jan. 13, 1989). These comments refer to language in the demonstration project regulations that is identical to language in the interest rate buydown regulations ("the reserve requirements ... may be from 0 up to 10 percent").

[118] 54 Fed. Reg. 1592 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § III.A.); prefatory comments, 54 Fed. Reg. 1546 (Jan. 13, 1989).

Step #2

The lender asks you to sell nonessential nonfarm assets.[119]

The lender and FmHA must determine whether you own any **nonfarm** assets that do not contribute to "essential family living expenses or to the maintenance of a sound farming operation." If you do own such assets, the lender must determine how much money you could get by selling them. Then the lender will figure out a new cash flow for you that includes that money. If you can cash flow with that money, you cannot get the buydown.

Step #3

The lender asks your other creditors to adjust debts.[120]

The lender may ask your other creditors to adjust the debts that you owe to them.

Step #4

The lender determines whether you can cash flow with the buydown.[121]

If you cannot cash flow after Steps #1, #2, and #3, the lender must determine whether you can cash flow with the buydown. The lender tries reducing your interest rate by 0.25 percent. If you cannot cash flow, the lender reduces it by another 0.25 percent. The lender keeps doing that until either you can cash flow or the figure reaches 4 percent.

If you cannot cash flow with a 4 percent reduction in your interest rate, you are not eligible for the program.

If you can cash flow with a reduction of 4 percent or less, you will be eligible for an interest rate reduction (provided you meet the tests at Steps #5 and #6). Most likely, you will be given the smallest reduction that will allow you to cash flow. The lender *may* give you up to the full 4 percent, though, even if you could cash flow with a smaller reduction.[122]

FmHA will pay the lender for half of the reduction, and the lender will pay for the other half.

If you are getting an interest rate buydown **with a write-down** (see discussion beginning on page 15.43), the buydown must be at least 1 percent.[123]

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[119] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.C); see also prefatory comments at 54 Fed. Reg. 1546 (Jan. 13, 1989).

[120] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.D); 7 C.F.R. Part 1903, Subpart A). If the lender does this, it must be done as outlined in 7 C.F.R. Part 1903, Subpart A.

[121] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.I).

[122] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.I).

[123] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.I).

Step #5 *You must show a positive cash flow for the first 24 months of the buydown period and after it expires.*[124]

The buydown period can last for up to three years. You must be able to show that you will have a positive cash flow *during the first 24 months* of the buydown. Also, if your loan repayment period will continue after the buydown period ends, you must show that you will have positive cash flow ***after the buydown period is over.***

Step #6 *The holder (if any) must agree to the buydown.*[125]

(See page 15.5 for a definition of "holder.") The holder must agree, in writing, to the interest rate reduction. If the holder refuses, the buydown cannot be approved unless the lender buys the loan back from the holder.

☐ Sixty-Day Foreclosure Freeze

As explained above, when "liquidation is imminent," the lender must ask FmHA to determine whether you are eligible for the interest rate buydown program. (See discussion beginning on page 15.30.) The lender **cannot initiate any foreclosure action** on your loan until 60 days after that determination has been made.

FmHA takes the position that the 60-day foreclosure freeze does not apply to loans for which the guarantee was issued before January 6, 1988. The statute supports FmHA's position. The regulations are broader than the statute; they seem to apply to pre-January 6 loans as well as to new loans.[126] Because of the explicit language of the statute, it seems unlikely that attempts to force FmHA to apply the 60-day foreclosure freeze to pre-January 6 loans will succeed.[127]

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[124] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.F).

[125] 54 Fed. Reg. 1593 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § IV.G).

[126] FmHA National AN No. 1911 (1980) (Apr. 25, 1989; expires Sept. 30, 1989). See "How the New Changes Apply to Old Loans," beginning on page 15.8.

[127] 7 U.S.C.A. § 1999(g); 54 Fed. Reg. 1592 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D, § II). The statute only requires that this 60-day foreclosure freeze be a provision in all contracts of guarantee entered into after January 6, 1988. The regulations are more broad: they apply the 60-day freeze to all guaranteed loans, whether or not the loan's contract of guarantee contains a provision regarding the freeze.

Releases of Farm Income May Be Difficult to Get

Releases of farm income for family living and farm operating expenses may be difficult to get.

Your lender may have a security interest in some or all of your farm products. (See page 7.21 for the definition of "security interest.") When you sell those products, your lender has certain rights to the money you get from the sale (the "sale proceeds"). Before you can use that money for anything (including family living and farm operating expenses), you will have to get your lender to **release its security interest**.

In FmHA's **direct** loan program, there are detailed procedures for getting releases.[128]

In the **guaranteed** loan programs, farmers have **no statutory right** to have income released. There are no regulations about releases. When you need to have income released, you must negotiate with your lender. When you negotiate, use the "Lender's Agreement" to support your argument that income should be released. You can use it in two ways.

First, the lender's refusal to release income might force you into default. That could happen in a number of ways. For example, if the lender will not release income that you need for fuel to get your crops out of the field, or to buy needed nutrients or medicine for livestock, you could end up losing production and, thus, lose income. This could force you to miss a payment. If the lender's failure to release your income forces you into default, the lender should arrange the "meeting upon default" described beginning on page 15.52. The Lender's Agreement says that, at that meeting, the lender must "negotiate in good faith in an attempt to resolve any problem to permit [you] ... to cure a default, where reasonable."[129] You may be able to argue that if the lender is negotiating in good faith to resolve your problem, the lender will release essential income.

Second, the Lender's Agreement says that the lender must act in a way that a "reasonably prudent" lender would act if the loan was not guaranteed.[130] You may be able to argue that in your situation a "reasonably prudent" lender would release essential income.

[128] See Chapter 8. In the direct loan programs, farmers have a statutory right to have farm income released if (1) they need it to pay for essential family living and farm operating expenses; and (2) their loan is not yet accelerated. 7 U.S.C.A. § 1985(f)(2) (West 1988). They also have a more limited statutory right to get releases if their loan is accelerated. 7 U.S.C.A. § 1985(f)(3) (West 1988).

[129] 54 Fed. Reg. 1551 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B ("Lender's Agreement"), § X.B).

[130] 54 Fed. Reg. 1549 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B ("Lender's Agreement"), § II).

Your Rights When You Cannot Pay

This section explains the things that your lender and FmHA can do to help you when you cannot pay your guaranteed loan. Read this section carefully. *Ask for these kinds of help if your lender and FmHA do not offer them to you.*

☐ Changes in Your Payment Plan: Loan Servicing

A. Introduction

FmHA uses the term "loan servicing" to describe the programs that it can use to change your payment plan and to reduce your debt. The loan servicing options for guaranteed loans are a lot like the options for direct loans. (See Chapter 10.) The options include reamortizing, rescheduling, consolidating, or deferring payments, reducing interest rates, and writing down principal and interest.[131] This section will explain those programs beginning on page 15.38.

The big news about loan servicing is the new debt write-down program. (See page 15.7 and the discussion beginning on page 15.43 for details.)

B. Do They Have to Help You?

In FmHA's **direct** loan programs, FmHA **must** give you loan servicing in most cases if you meet the eligibility rules for loan servicing. In the **guaranteed** loan programs, it is not so simple. In the guaranteed programs, even if you meet the eligibility rules, the lender has some **discretion** about whether to give you loan servicing. There is no real clear answer to the question, "Do they have to help you?"

FmHA's regulations say that the lender *may* give you loan servicing help if:

- You meet the eligibility rules; and
- The lender gets FmHA's approval of its decision to give you loan servicing.[132]

You cannot get loan servicing unless the lender decides to give you loan servicing. You can use parts of the regulations and the lender's agreement to make a strong argument that in some cases the lender *should* give you loan servicing. Here is an explanation of some of those arguments.

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[131] FmHA's regulations describe servicing for guaranteed loans in detail. 54 Fed. Reg. 1566-69 (Jan. 13, 1989) (to be codified at 7 C.F.R. §§ 1980.124 and 1980.125); 54 Fed. Reg. 1592-94 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D).

[132] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)); 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)).

1. The Lender Must Negotiate With You In Good Faith[133]

When you miss a payment on your guaranteed loan and you are unable to bring your account current in 30 days, FmHA and the lender are supposed to meet with you. (See discussion beginning on page 15.52.) At that meeting, the lender is required to negotiate in good faith with you to try to solve your problem.[134] You can argue that the lender is not negotiating in good faith unless the lender considers you for loan servicing.

2. The Lender Must Consider You for Loan Servicing

The lender's agreement lists loan servicing options. The lender and FmHA signed a paper called the "lender's agreement" when you got your loan. The lender's agreement says that the lender must consider you for loan servicing, and the agreement lists many different kinds of loan servicing.[135] The agreement says that the lender can take any combination of loan servicing actions with written approval from FmHA.

Use that list. Show your lender and FmHA the list of loan servicing options in the lender's agreement to remind them that they are supposed to consider you for loan servicing.

One problem. On lender's agreements that were signed before January 13, 1989, "principal and interest write down" was not included in the list of loan servicing options. (Starting January 13, 1989, FmHA should use a new lender's agreement form that includes a reference to principal and interest write-down.)[136] If your lender and FmHA signed the lender's agreement before January 13, 1989, the list will not help you to get a debt write-down. You can still rely on the list to argue that you should be considered for the *other* kinds of loan servicing. If you want a debt write-down, you can rely on the debt write-down *regulations.*[137] The lender's agreement incorporates the regulations, including "any future amendments to these regulations not inconsistent with" the lender's agreement.[138]

You can argue that as part of the lender's obligation to negotiate in good faith, the lender must consider you for all of the programs that could help you under the current law.

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[133] 54 Fed. Reg. 1551 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B, "Lender's Agreement," § X.B).

[134] The exact language is "negotiate in good faith in an attempt to resolve any problem to ... cure ... [your] default, where reasonable." 54 Fed. Reg. 1551 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B, § X.B).

[135] 54 Fed. Reg. 1551 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B, § X.A).

[136] 54 Fed. Reg. 1551 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B, § X.A).

[137] 54 Fed. Reg. 1567-69 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125). But FmHA may take the position that this determination involves liquidation and that, therefore, the lender can choose to proceed under the old regulations. See discussion beginning on page 15.8.

[138] 54 Fed. Reg. 1553 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B, § XVII). See also the 1985 version of the lender's agreement at 7 C.F.R. Part 1980, Subpart A, Appendix B, § XVI.

3. The Lender Must Do What a Reasonably Prudent Lender Would Do

The lender must do what a *reasonably prudent* lender would do, or else the lender loses the guarantee.[139] The lender's agreement says that FmHA does not have to pay the lender for the guaranteed portion of a loss if the loss was caused by "negligent servicing."

Negligent Servicing

The failure to perform services that a reasonably prudent lender would perform in servicing its own portfolio of loans that are not guaranteed.[140]

If your lender does not want to give you any loan servicing, think about whether a "reasonably prudent" lender would be willing to help you. If the answer is yes, explain to your lender that he or she may lose the guarantee if he or she refuses to help you.

Note: If your lender is a Farm Credit System (FCS) lender (a PCA or Federal Land Bank), it should have its own restructuring policies. You have a strong argument that to be "reasonably prudent," they must consider you for all of the FCS restructuring programs as well as all of the FmHA loan servicing programs.

C. Types of Loan Servicing

There are seven types of loan servicing: consolidation, rescheduling, reamortization, deferral, refinancing, reduced interest rates, and write-down.

1. Consolidation[141]

Consolidation means to *combine* the outstanding principal and interest balances of two or more loans.[142] Consolidation is available for:

- OL loans that are not secured by real estate.[143]
- *Some* OL lines of credit.[144]
- EM loans made for operating purposes that are *not* actual loss loans. This includes EM loans for annual operating purposes, and EM major adjustment loans for operating purposes.[145]

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[139] 54 Fed. Reg. 1549 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B, § II).

[140] 54 Fed. Reg. 1549 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B, § II).

[141] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)).

[142] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(1)).

[143] 54 Fed. Reg. 1566-67 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(1) and (5)).

[144] An existing OL line of credit may be consolidated with a new OL line of credit if the terms (to make advances as well as final maturity date) of the new line of credit are within the terms of the existing line of credit. 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(1)).

[145] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(3) and (5)).

If a loan has an outstanding interest rate buydown agreement or shared appreciation agreement, it cannot be consolidated.[146]

There is no limit on the number of times a loan may be consolidated, provided that all interest payments are being made and a principal payment is made that is at least equal to the amount of depreciation on the security.[147]

The new note or line of credit that exists after a consolidation occurs must be repaid over a period not to exceed 15 years from the date of consolidation for Loan Note Guarantees, or 7 years from the date of consolidation for Line of Credit Contract Guarantees.[148]

The interest rates for consolidated loans are explained in the following chart. If the loan/line of credit has an outstanding interest rate buydown in effect at the time of consolidation, the interest rate will remain the same until the buydown period is over.[149]

Interest Rates for Rescheduled or Consolidated Guaranteed Loans

Type of Loan	**INTEREST RATE After Rescheduling or Consolidation**
OL Loan	Negotiated rate agreed upon by you and the lender, within the limits of interest that may be charged on guaranteed OL loans 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(9)) (See page 16.11.)
OL Line of Credit	Same as above.
EM Loan for Operating Purposes	Rate in effect for similar types of FmHA loans at the time of the rescheduling or consolidation. 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(8))

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[146] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(5)).

[147] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(6)).

[148] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(10)). However, (1) if the loan is solely for recreation and/or nonfarm enterprise purposes, it must be paid back within seven years; and (2) if an existing line of credit is consolidated with a new line of credit, the terms (to make advances as well as final maturity date) cannot exceed the terms of the existing line of credit.

[149] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(9)).

2. Rescheduling

Rescheduling means *rewriting* the rates and/or terms of your promissory note or line of credit.[150] It does not change your principal balance, but it can change your payment plan to better fit your needs.

Rescheduling[151] is available for:

- EM loans made for operating purposes.
- OL loans.
- OL lines of credit.

There is no limit on the number of times a loan may be rescheduled, provided that all of the interest payments are being made and a principal payment is made that is at least equal to the amount of depreciation of the security.[152]

The new note or line of credit that exists after a rescheduling occurs must be repaid over a period not to exceed 15 years from the date of rescheduling for Loan Note Guarantees, or 7 years from the date of rescheduling for Line of Credit Contract Guarantees.[153]

The interest rates for rescheduled and consolidated loans are explained in the chart on page 15.39. If the loan/line of credit has an outstanding interest rate buydown in effect at the time of consolidation, the interest rate will remain the same until the buydown period is over.[154]

3. Reamortization

Reamortization *changes your payment schedule* to better fit your needs.

Reamortization is like rescheduling, but it is for loans that were made for real estate purposes,[155] including FO loans, SW loans, EM actual loss loans (if the basic security is real estate), and EM major adjustment loans made for real estate purposes.

A reamortized guaranteed loan must be scheduled to be paid back within 40 years of the date of the original note.[156]

The interest rates for reamortized loans are explained in the following chart. If there is an outstanding interest rate buydown in effect at the time of reamortization, the interest rate will remain the same until the buydown period is over.[157]

[150] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(2)).

[151] 54 Fed. Reg. 1566-67 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(2) and (4)).

[152] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(6)).

[153] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(10). However, if the loan is solely for recreation and/or nonfarm enterprise purposes, it must be paid back within seven years.

[154] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(9)).

[155] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(c)).

[156] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(c)).

[157] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(c)(4)).

Interest Rates for Reamortized Guaranteed Loans*	
Type of Loan	**INTEREST RATE After Reamortization**
EM Actual Loss Loan	Same rate as the original loan
EM Major Adjustment Loan for Real Estate Purposes	Market rate in effect for similar type of loans at the time of the reamortization
FO Loan	Negotiated rate agreed upon by you and the lender, within the limits of the interest that can be charged for FO loans. (See page 16.11.)
SW Loan	Negotiated rate agreed upon by you and the lender, within the limits of the interest that can be charged for SW loans. (See page 16.11.)
RL Loan	Same as for FO and SW loans

* 7 C.F.R. § 1980.124(c)(2)-(4).

4. Deferrals[158]

Deferral means to *postpone* the payment of interest and/or principal on your guaranteed loan. Principal may be deferred in whole or in part. Interest may be deferred only in part.

Deferrals are available for guaranteed FO, OL, SW, RL, and EM loans and OL lines of credit.

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[158] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(d)).

Payments may be deferred until a time no later than:

- Five years after the date of the deferral, or
- The final due date of the note,

whichever is earlier.[159]

To be eligible for a deferral,[160] the lender must determine:

- That you cannot make your payments for *reasons beyond your control* (see page 15.47 for an explanation of "beyond your control"); and
- That there are *reasonable prospects* that you will be able to start making full payments again at the end of your deferral period.[161]

5. Refinancing

Refinancing allows you to get an FmHA direct loan to buy out your guaranteed loan. (See discussion beginning on page 15.10 for an explanation of how you can do this.)

6. Reduced Interest Rates

If you are not able to make your guaranteed loan payments, you may be able to get your interest rate reduced, which could make your payments smaller. There are three different methods which you could use to try to get an interest reduction:

- You can apply for the **interest rate buydown program.** See the discussion beginning on page 15.30. Note that if "liquidation is imminent," the lender *must* ask FmHA to determine your eligibility for the interest rate buydown program.

- You can try to **refinance** your guaranteed loan with an FmHA direct OL or FO loan at the limited resource (LR) interest rate. See the discussion beginning on page 15.13 for an explanation of the rules for this kind of refinancing. See the discussion beginning on page 10.9 for an explanation of limited resource interest rates.

- You can ask the lender to simply **reduce your interest rate.** As explained on page 15.52, if your loan payment is 30 days past due, or if you are otherwise in default, the lender is supposed to arrange a meeting between you, the lender, and FmHA. At that meeting, the lender is supposed to negotiate with you to resolve your problem. Among other things, the lender is supposed to consider changing your interest rate.[162] The lender is supposed to negotiate with you in good faith.[163] You can point out that under the new regulations lenders cannot charge as much interest as they could charge under the old regulations. (See the note on the bottom of page 15.15.)

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[159] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(d)(2)).

[160] See discussion beginning on page 15.48 for more details about eligibility.

[161] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(d)(3)).

[162] 54 Fed. Reg. 1551 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B, § X.A.8).

[163] 54 Fed. Reg. 1551 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B, § X.B).

7. Write-Down of Principal and Interest

The old law. Before the passage of the Agricultural Credit Act of 1987,[164] farmers found it almost impossible to get lenders to write down their guaranteed loans. FmHA took the position that they could not "pay on a loss" unless the security property was liquidated. That meant that if the lender wrote down a loan, FmHA would not pay the lender any part of the write-down: the lender had to absorb that cost itself. FmHA would only pay the lender's loss if the lender foreclosed or made other arrangements for the farmer to completely give up the security property.

The new law. The Agricultural Credit Act of 1987 (the "Act")says that *if the lender writes down a loan with FmHA's approval, FmHA must pay the loss.* Here's an example of how that works. Suppose you have a 90 percent guarantee on your loan. If your loan is for $180,000 and the lender writes it down to $80,000, the lender has a $100,000 loss. FmHA will pay that lender $90,000, which is 90 percent of the loss.

What Happens to You	
Your Original Loan	$180,000
Write-Down	-100,000
Your New Loan Balance	$ 80,000

What Happens to Your Lender	
Loss (the write-down)	$100,000
	x 90%
FmHA pays the lender $90,000, which is 90% of the loss	$ 90,000

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[164] Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 1568 (1988) (relevant portions codified at 7 U.S.C. § 1921, et. seq.).

The Act also says that FmHA *must* approve the lender's request for permission to write down your loan if your cash flow numbers meet a certain formula.[165] That formula is explained beginning on page 15.49.

The details of the guaranteed loan write-down program are very similar to the details of the FmHA direct loan write-down program. The formula and the shared appreciation agreement are almost the same as in the direct loan program. The biggest difference is that **there is no net recovery value buyout in the guaranteed loan program.** (See page 10.18 for an explanation of how the buyout works in the direct loan program.)

a. Eligibility

The eligibility rules for debt write-down are different from the eligibility rules for the other kinds of loan servicing. The rules are explained beginning on page 15.48.

b. Shared Appreciation

If your lender writes down your debt with FmHA's approval and the debt was secured by **real estate,** you will be required to sign a *shared appreciation agreement.*[166] This agreement provides that if the land that is security for the loan *increases in value* during a certain time period, you must pay FmHA a percentage of the increase in value. The security for the written-down loan should be the same property that was security for the original loan.[167]

Length of the agreement.[168] The shared appreciation agreement can last for up to ten years. The agreement will end on the *earliest* of these four dates:

- The date the *agreement ends;*
- The day you *stop farming;*
- The day you *pay your loan in full;*
- The day you *transfer title* to the land that is security for the loan.[169]

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[165] This statutory provisions calls into question the legality of the regulatory eligibility criteria.

[166] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. §§ 1980.125(a)(5) and 1980.125(c)). The actual shared appreciation agreement is printed in the *Federal Register* at 54 Fed. Reg. 1596 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit F).

[167] The guaranteed loan shared appreciation statute cross-references the direct loan shared appreciation statute and adopts its terms. 7 U.S.C.A. § 2005(b)(3) (West 1988). The regulations do not say whether additional collateral will be required. The regulations talk about additional security *instruments,* but not additional *security.* 54 Fed. Reg. 1569 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(d)(5)). There is a strong argument based on the statute that additional security is not allowed. Contact Farmers' Legal Action Group for details.

[168] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(c)(1)-(3)).

[169] But if title is transferred to the spouse of the borrower upon the death of the borrower, the transfer will not trigger the end of the shared appreciation agreement. 54 Fed. Reg. 1569 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(c)(3)).

The amount that you owe.[170] You will owe a certain *percentage* of the amount by which the security property increased in value. FmHA will calculate the increase in value based on the **difference between:**

- The market value of the security property on the day the agreement was **signed;** and
- The market value of the security property on the day the agreement **ends.**

The market value will be determined by appraisals conducted by the lender.[171]

The amount that you owe depends upon when the shared appreciation agreement ends. If it ends in the *first four years* after you signed it, you will owe FmHA *75 percent* of the amount by which the land securing the loan appreciated in value. If it ends *more than four years after* you signed it, you will owe FmHA *50 percent* of the amount by which the land securing the loan appreciated in value. But under this agreement, *you can never owe FmHA more than the amount FmHA wrote off.*[172]

End of Agreement	**Percentage of Amount of Appreciation That You Owe**
Years 1 through 4	75%
Years 5 through 10	50%

The amount that you owe FmHA is called the *recapture* amount.

What happens if you do not pay the recapture amount? The shared appreciation agreement says: "Repayment of the recapture amount may be rescheduled or reamortized if the borrower is unable to pay the recapture amount at the expiration date of this agreement."[173]

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[170] 54 Fed. Reg. 1569 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(c)(2)); 54 Fed. Reg. 1596-97 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit F).

[171] 54 Fed. Reg. 1597 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit F).

[172] 54 Fed. Reg. 1569 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(c)(5)).

[173] 54 Fed. Reg. 1597 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit F).

c. Principal Will Be Written Down Before Interest

The regulations say: "The debt write-down will be on principal first and then accrued interest, if needed."[174] ***This may create serious tax consequences.*** Get tax advice before you accept a write-down. When you have your tax advisor consider the tax consequences of the write-down, be sure that he or she knows about this rule.

d. No Net Recovery Value Buyout

There is no net recovery value buyout in the guaranteed loan program. (See discussion beginning on page 10.18 for an explanation of how net recovery value buyout works in the FmHA direct loan program.)

e. Write-Down Can Be Combined With Other Types of Loan Servicing

In the **direct** loan program, there is a detailed procedure involving the DALR$ computer program that FmHA must follow to determine what combination of loan servicing programs works best for you. (See the discussion of the DALR$ program beginning on page 10.27.)

In the **guaranteed** loan regulations, there is no mention of any procedure for deciding what combination of loan servicing works best. There is no computer program like DALR$. The only mention of combining types of loan servicing is a regulation which says that if a positive cash flow cannot be achieved by using consolidation, rescheduling, reamortization, and/or deferral, it is possible to use interest rate buydown with a write-down if that will result in a positive cash flow.[175] There is an argument that these regulations *imply* that you can use any combination of loan servicing tools that will work.

f. Consider Tax Consequences

If you are considering entering into a debt write-down agreement, **look into the tax consequences of the write-down before you sign the agreement!** You may think that you are getting yourself out of debt and then find that you owe a lot of money to the IRS. Remember that principal is written down before interest. (See discussion above.) Have an experienced tax advisor evaluate your situation for you. (FLAG has a packet of materials available that may be helpful to your tax advisor. See the publications list at Appendix C for more information.)

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[174] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)(10)).

[175] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)(1)).

D. Eligibility for Loan Servicing

1. Rescheduling, Reamortization, and Consolidation Eligibility

To be eligible for rescheduling, reamortization, and/or consolidation, you must meet the following requirements:

a. The loan servicing action will assist in the orderly collection of your loan.[176]

b. You meet the eligibility and security requirements that you would have to meet to get a new loan guarantee.[177]

c. The lender's security position will not be hurt.[178]

d. The loan servicing action will ensure that you will be able to continue your farming operation.[179]

e. Any delinquency is due to circumstances beyond your control.[180] The "circumstances" must be one of the following:

- Your income has been reduced, and the reduction was *not* caused by your "inadequate or poor financial management decisions";[181]
- Unforeseen but essential farm expenses or essential family living expenses; or
- A natural disaster, such as a drought or flood, regardless of whether the area has been declared a disaster area.

f. You have acted in *good faith* by "demonstrating sincerity and honesty in meeting agreements with and promises made to the lender. This includes cooperating in servicing the account and maintaining the security."[182]

g. The lender determines that you *cannot* develop a positive cash flow with your existing payment schedule and that you *can* develop one with the revised payment schedule.[183]

h. The holder (if any) must agree in writing to any rescheduling, reamortization, or deferral.[184]

[176] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)).
[177] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)(1)).
[178] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)(1)).
[179] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)(2)).
[180] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)(3)).
[181] The regulations explicitly state that untimely marketing practices that might occur when a borrower has forward contracted and the price continues to increase do not constitute poor financial management. 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)(3)(i)). See also prefatory comments at 54 Fed. Reg. 1541 (Jan. 13, 1989).
[182] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)(4)).
[183] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)(5)).
[184] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)(6)).

2. Deferral Eligibility

To be eligible for a deferral, you must meet all of the eligibility rules described above in paragraphs (a)-(h) on page 15.47,[185] and the lender must also determine that there are "reasonable prospects" that you will be able to begin to make full payments again at the end of the deferral period.

3. Interest Rate Buydown Eligibility

See discussion beginning on page 15.32 for an explanation of the eligibility rules for the interest rate buydown program.

4. Debt Write-Down Eligibility

a. The Requirements

To be eligible for debt write-down, you must meet the following eligibility requirements:[186]

- Your debt must be delinquent.[187] This means that you must have missed at least one payment.
- You meet the eligibility rules for rescheduling, reamortization, and consolidation described in paragraphs (d), (e), (f), and (g) on page 15.47.[188]
- Your cash flow numbers meet the formula.[189] (See discussionbelow.)
- If the loan that is going to be written down is secured by real estate, you must sign a shared appreciation agreement.[190] (See page 1544–15.45.)
- The holder(s) (if any) must agree in writing.[191]

Also, you should be aware that your lender may ask your other major creditors to voluntarily adjust the debts that you have with them.[192]

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[185] There is one small difference which seems to be an error in the regulations. The deferral regulations say that the delinquency must be due to "reasons beyond the borrower's control as defined in paragraphs (a)(3)(i) and (ii) of this section...." 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(d)(3)). That passage should say, "(a)(3)(i), (ii) *and (iii)*." The omitted paragraph, § 1980.124(a)(3)*(iii)*, refers to delinquencies caused by natural disasters. It seems extremely unlikely that a reference to that paragraph was omitted on purpose.

[186] There is a strong argument based on the *statute* that the only legal eligibility criterion for debt write-down is that the numbers meet the formula. See 7 U.S.C.A. § 2005(b)(2); see also footnote 201 on page 15.50.

[187] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)).

[188] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)(3)).

[189] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)(2)).

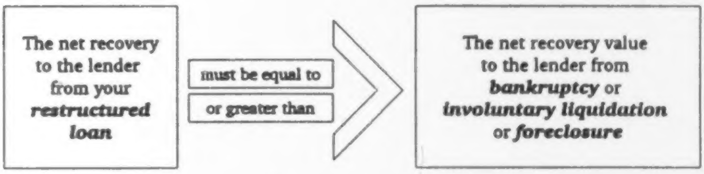
[190] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)(5)).

[191] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)(6)).

[192] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)(4)). This process should be handled in accordance with 7 C.F.R. Part 1903.

b. The Formula[193]

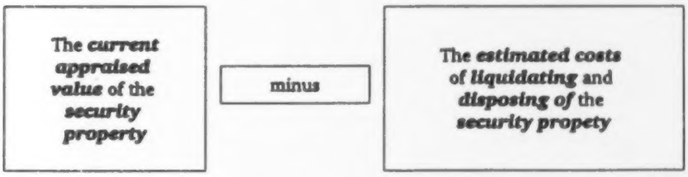
To be eligible for a debt write-down, your cash flow numbers must meet a certain formula. The formula is almost exactly the same as the formula for debt write-down in the direct loan program. (See discussion beginning on page 10.17.)


The net recovery to the lender from your ***restructured loan***
must be equal to
or greater than
The net recovery value to the lender from ***bankruptcy*** or ***involuntary liquidation*** or ***foreclosure***

You meet the formula if the lender would get more money by restructuring your loan than by having you go through bankruptcy or involuntary liquidation or foreclosure.

The *lender* determines the two figures. The details about how the lender is supposed to calculate the figures are explained below.

- **Net recovery from your restructured loan.**[194] The lender figures this out by calculating the *present value* of the payments that you would make according to the terms of the restructured loan. (See discussion beginning on page 10.20 for an explanation of "present value.")
- **Net recovery from bankruptcy or involuntary liquidation or foreclosure.**[195] The lender must base this calculation on "the current appraised value of the security *less* the estimated costs associated with liquidation and disposition of the ... security."


The ***current appraised value*** of the ***security property***
minus
The ***estimated costs*** of ***liquidating*** and ***disposing of*** the ***security propety***

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[193] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)(2) and (b)).
[194] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(b)(2)).
[195] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(b)(1)).

The lender selects the appraiser. The current *appraised value* will be determined by an independent appraiser who is *selected by the lender* and approved by FmHA.[196] The appraisal fee will be shared equally by the lender and FmHA. (See discussion beginning on page 15.29 for an explanation of the appraisal rules.) The regulations list the types of liquidation costs that must be considered by the lender.[197]

The lender decides what numbers to use as inputs for the "estimated costs" in the formula. In the FmHA **direct** loan program, *FmHA* decides what numbers to use for the various inputs in the formula (such as depreciation, resale expenses, attorneys' fees, etc.). In the **guaranteed** program, the *lender* determines net recovery value. FmHA does not tell the lender what numbers to use.[198] Therefore, you can try to negotiate with the lender about what those numbers should be.

c. The Lender Must WANT to Write Down Your Loan

Even if you meet all of the eligibility rules for debt write-down, you cannot get a debt write-down unless *your lender decides to pursue it for you.* (See discussion beginning on page 15.36 for an explanation of how you can argue that the lender must pursue it for you.)

d. If the Formula Works, FmHA MUST Approve the Write-Down

The Agricultural Credit Act of 1987 says that FmHA "shall approve" the lender's request to write down your loan if the numbers meet the formula.[199] Then, if FmHA approves the write-down, FmHA must pay the lender for its loss.[200]

This language from the statute is the basis for an argument that all of the other eligibility rules for debt write-down (see page 15.47) are illegal.[201]

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[196] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(b)(1)(i)).

[197] The cost items that must be calculated for the lender's average holding period, in the state in which the property is located, and for the type of property involved, are: payment of prior liens, taxes and assessments; depreciation; management costs; yearly percentage increase or decrease in the value of the property; and lost interest income. Other cost items are: resale expenses such as repairs, commissions, and advertising; and other reasonable and necessary administrative costs, including attorneys' fees. Lease income that will be generated while the property is in inventory will offset the items listed above.54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(b)(1)(i) and (ii)).

[198] 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(b)).

[199] 7 U.S.C.A. § 2005(b)(2) (West 1988).

[200] 7 U.S.C.A. § 2005(b)(1) (West 1988).

[201] In the *direct* loan write-down program, the eligibility criteria (such as "good faith" and "delinquency for reasons beyond your control") are prescribed in the statute. 7 U.S.C.A. § 2001(b) (West 1988). For the guaranteed loan write-down program, there are no eligibility criteria in the statute. Moreover, the statute explicitly says that if the numbers meet the formula, the Secretary "shall approve." 7 U.S.C.A. § 2005(b)(2) (West 1988). This language seems to preclude the Secretary from imposing eligibility criteria that would interfere with approval in situations where the numbers meet the formula. The logic to support this argument is that Congress intentionally left all eligibility determinations other than economic feasibility to the *lenders* in the guaranteed program.

E. Authorities: Who Can Approve Loan Servicing Actions?

The lender is not supposed to give you loan servicing without first getting FmHA's approval.[202] The county supervisor has the authority to approve deferrals, rescheduling, or reamortization. The state director must approve all write-downs.[203]

F. If Your Bank Fails, Your Loan Servicing May Be Cancelled

If your lender is a bank and your bank fails, your loan servicing may be cancelled. Here's why.

If your bank fails, the Federal Deposit Insurance Corporation (FDIC) may end up owning your loan.[204] The FDIC does not have to honor any agreements that you made with the failed bank unless the agreement meets four very specific rules.[205] One of those rules is that the agreement (here, the loan servicing action) was made at the same time the loan was made. To meet this rule, your lender would have to re-write your loan note when you enter into the loan servicing agreement. Under the new guaranteed loan regulations, in most cases your lender cannot do that. The regulations say that no new note can be taken when:

- A loan/line of credit is rescheduled (unless the loan/line of credit is also being consolidated);[206] or
- A loan is reamortized;[207] or
- A debt is written down.[208]

Perhaps FmHA will be willing to change these rules if there is sufficient public comment about the potential risks to farmers.

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[202] 54 Fed. Reg. 1566 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(a)); 54 Fed. Reg. 1568 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(a)).

[203] Prefatory comments, 54 Fed. Reg. 1543 (Jan. 13, 1989).

[204] For a detailed explanation of how this works, see *Farmers' Guide to FDIC.* (See the publications list at Appendix C.)

[205] 12 U.S.C. § 1823(e) (West Supp. 1989) reads: "No agreement which tends to diminish or defeat the right, title or interest of the Corporation in any asset acquired by it under this section, either as security for a loan or by purchase, shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the bank and the person or persons claiming an adverse interest thereunder, including the obligor, *contemporaneously with the acquisition of the asset by the bank,* (3) shall have been approved by the board of directors of the bank or its loan committee, which approval shall be reflected in the minutes of said board or committee, and (4) shall have been, continuously, from the time of its execution, an official record of the bank." (Emphasis added.)

[206] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(b)(7)).

[207] 54 Fed. Reg. 1567 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.124(c)(1)).

[208] 54 Fed. Reg. 1569 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.125(d)(1)).

☐ What Should Happen When You Have Trouble Paying Your Loan

FmHA and your lender are supposed to take certain steps to help you when you have trouble paying your loan. These steps are explained below.

A. The Meeting Upon Default

If you are more than 30 days past due on a guaranteed loan payment, or if you are otherwise in default, the lender must set up a meeting between you, the lender, and FmHA.[209] The purpose of the meeting is to try to resolve your problems.

> **Default**
>
> When you sign your initial loan papers, you agree to do several things. Your agreements may include: making your payments on time, keeping your security property in good condition, keeping your real property insured, paying real estate taxes, and so on. *If you break any of those agreements, the lender may declare that your loan is in default.*

At least ten working days before the meeting, the county supervisor must mail a written explanation of the interest rate buydown programs to you and to your lender.[210]

When you have the meeting, you should insist that the lender and FmHA discuss how loan servicing might help you. The lender has an obligation to consider all of the different servicing options explained beginning on page 15.38. (See discussion beginning on page 15.36 for an explanation of the lender's obligation to help you.)

- Consolidation (page 15.38).
- Rescheduling (page 15.40).
- Reamortization (page 15.40).
- Deferrals (page 15.41).
- Refinancing (page 15.10).
- Reduced Interest Rates (page 15.42).
- Write-down of principal and interest (page 15.43).

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[209] 54 Fed. Reg. 1551 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B ("Lender's Agreement"), § X).

[210] 54 Fed. Reg. 1571 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.145(b)). The written explanation is in the regulations at 54 Fed. Reg. 1592-94 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit D).

The lender also has an obligation to consider any other kinds of loan servicing, debt restructuring, or forbearance that a "reasonably prudent" lender would consider if the loan were not guaranteed.[211] If your lender is a Federal Land Bank (FLB) or a Production Credit Association (PCA), you should check their written policies about debt restructuring or forbearance. Ask to have those policies applied to your loan if it will help you.

Record of the Meeting. The lender must prepare a record of this meeting. The original must be filed in the lender's loan file, and copies must be given to you and the county supervisor. The record must include a list of the people who attended the meeting and a summary of the problem and suggested solutions.[212]

If you and the lender propose a plan that is denied (in whole or in part) by FmHA, FmHA must send you and the lender a letter explaining the reasons for the denial within ten days after FmHA makes its decision. The letter must also explain your appeal rights.[213]

If the lender and FmHA did not invite you to this meeting, or if you attended the meeting but they did not negotiate in good faith, try to **appeal**. (See discussion beginning on page 15.56 for an explanation of your appeal rights.) If you cannot appeal, see a lawyer.

B. Interest Rate Buydown Consideration

Mandatory consideration. When you are 30 days in default (and unable to bring your account current within 30 days), or when "liquidation is imminent," FmHA and the lender must consider you for an interest rate buydown. (See discussion beginning on page 15.31 for an explanation of the details.)

Sixty-day foreclosure freeze. When "liquidation is imminent," the lender cannot initiate any foreclosure action until 60 days after the decision about the interest rate buydown. (See discussion beginning on page 15.34 for an explanation of the details.)

FmHA takes the position that mandatory consideration and the 60-day foreclosure freeze only apply to new loans.[214] (See discussions beginning on page 15.8 and 15.34.)

C. Mediation[215]

If your state has a farm credit mediation program, your *lender* must participate in it according to the rules of the program. *FmHA* will not attend these mediation sessions.

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[211] 54 Fed. Reg. 1549 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B ("Lender's Agreement"), § II).

[212] 54 Fed. Reg. 1571 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.145(c)).

[213] 54 Fed. Reg. 1571 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.145(d)).

[214] FmHA National AN No. 1911 (1980) (Apr. 25, 1989; expires Sept. 30, 1989).

[215] 54 Fed. Reg. 1569 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.126); see also prefatory comments at 54 Fed. Reg. 1542 (Jan. 13, 1989).

The regulations say that the lender must not agree to any plan that involves rewriting the terms of your note(s) *unless the plan complies with FmHA's loan servicing rules.* (See discussion beginning on page 15.38.)

All mediation agreements must be approved by the FmHA state director or his/her designee. The regulations say that FmHA is not bound by a mediation agreement or a mediator's findings unless FmHA agrees to them in writing.[216]

D. The Decision to Liquidate

The lender's agreement says that the lender cannot liquidate your loan without FmHA approval.[217]

If the lender decides that it is necessary to liquidate your guaranteed loan, it must arrange a meeting with FmHA. The lender and FmHA do not have to invite you to this meeting. When FmHA agrees that the loan must be liquidated, or if FmHA decides on its own that the loan must be liquidated, FmHA must notify the lender.

Your appeal rights. The statute says that all "adverse actions" are appealable.[218] That means that when FmHA makes the decision to liquidate your loan, FmHA should give you notice and a chance to appeal. But the regulations and the guaranteed loan agreements do not recognize that you have the right to notice, a meeting, and a hearing before liquidation. Therefore, if the lender decides to liquidate your loan, you may not find out about it until you receive your "Notice of Acceleration." In that case, see a lawyer. FmHA's failure to give you the notice and a chance for an appeal hearing may provide a defense that you could use in a foreclosure lawsuit. (See discussion beginning on page 15.56 regarding appeal rights.)

Usually the Lender Liquidates the Loan, but in some cases FmHA does it.[219] If the lender is going to liquidate the loan, it must submit a detailed liquidation plan to FmHA for approval. The lender must submit the plan within 30 days after it makes the decision to liquidate.

☐ Educate Your Banker!

FmHA is not giving **notice** of its write-down program to farmers or to bankers. Therefore, very few people know that it exists! If you want to get the help that you are entitled to get, you will have to educate your banker. Explain your rights to him/her. Show him/her a copy of this chapter. (You can order a copy of an article that is a shorter version of this chapter, too. See the publications list at Appendix C.)

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[216] This regulatory provision may be subject to challenge. The Agricultural Credit Act of 1987 says that federal lenders must participate in certain mediation programs. 7 U.S.C. § 5104 (1988). Where this provision conflicts with a provision of a state mediation law, the state mediation law might prevail. Watch for situations in which the delay caused by FmHA's approval process means that the lender cannot get authority to enter into an agreement within the time frame established by state law.

[217] 54 Fed. Reg. 1551-53 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B ("Lender's Agreement"), § XI).

[218] See footnote 10 on page 11.6.

[219] 54 Fed. Reg. 1551 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart A, Appendix B ("Lender's Agreement"), § XI).

Defenses to Foreclosure

If FmHA or a lender decides to liquidate or foreclose your guaranteed loan, you should examine the liquidation procedure that they used to see if they violated any of your rights. If they did, there may be a defense that you could raise in a lawsuit. Following is a list of some possible defenses that you and your lawyer should consider. These defenses may or may not be useful, depending upon the facts of your case and the state of the law in your jurisdiction.

☐ Defense #1—Failure to Hold Meeting Upon Default

One such defense may be that the lender failed to hold a meeting between the lender, FmHA, and you to discuss methods that they could use to resolve your default. (See discussion beginning on page 15.5.) You should argue that you are an "intended beneficiary" of the contractual agreements between the lender and FmHA on the guarantee, and that the failure to hold such a meeting is a violation of those agreements, as well as a violation of federal regulations. (The *Parker* case will affect this argument. See footnote 221 on page 15.55.)

☐ Defense #2—Failure to Negotiate in Good Faith

A second defense may be to argue that when the parties did discuss methods to resolve the default on the loan, the lender failed to negotiate in good faith. (See discussion beginning on page 15.37.) In its agreement with FmHA, the lender has specifically agreed to negotiate in good faith to resolve your problems.[220] Again, you could raise this defense by arguing that you are an "intended beneficiary" of the contractual agreement between FmHA and the lender.[221]

☐ Defense #3—Failure to Honor Appeal Rights

A third defense may be that FmHA violated the statute because it made decisions that were adverse to you (for example, allowing liquidation and/or denying the use of loan servicing) without providing you with a written notice and an opportunity to appeal. (See discussion of appeal rights beginning on page 15.56.)[222]

☐ Defense #4—Due Process Violation

A fourth defense may be that FmHA violated the Due Process Clause of the United States Constitution by allowing the liquidation of your property, or by denying you loan servicing, without providing you with a written notice and/or an opportunity to appeal its decision. But see *Parker v. Lyng* (see footnote 221 on page 15.55).

[220] See "Lender's Agreement," paragraph X(A) (see footnote 133 on page 15.37).

[221] But see *Parker v. Lyng*, 879 F.2d 1362 (6th Cir. 1989), petition for rehearing filed, No. 88-5694 (6th Cir. July 27, 1989).

[222] This argument was decided *against* the farmer in *Parker v. Lyng* (see footnote 221 on page 15.55).

Transfer and Assumption of Guaranteed Loans

Transfer and assumption is a way to end your loan. It means that you **transfer** your security property to somebody else, and he/she **assumes** your debt.

The FmHA **direct** loan program transfer and assumption rules are discussed in detail beginning on page 12.8.

FmHA has detailed regulations on **guaranteed** loan transfer and assumption.[223] If you are considering entering into a transfer and assumption, have your lawyer or advocate review those regulations.

Appeal Rights

Arguably, the statute gives you the right to appeal any FmHA decision that "directly and adversely" affects you concerning a guaranteed loan.[224] This would include decisions such as:

- FmHA's denial of your guaranteed loan application;
- FmHA's refusal to allow you to have loan servicing; or
- Any other decision made by FmHA that hurts you.

According to the regulations, you can appeal FmHA's decisions ***only if the lender will join you*** in the appeal.[225] This can be a big problem for you because the lender might not want to join you in your appeal.

If you want to appeal and your lender will not join you, see a lawyer. Make sure that your lawyer knows about the *Parker* case.[226] You and your lawyer can determine whether you should sue FmHA to enforce your appeal rights. Bring a copy of this book to your meeting with your lawyer, and tell him/her that further information is available by contacting Farmers' Legal Action Group, Inc., 1301 Minnesota Building, 46 East Fourth Street, St. Paul, Minnesota, 55101.

[223] 54 Fed. Reg. 1565-66 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.123).

[224] The statute extends appeal rights to anyone who is "an applicant for or recipient of a loan guarantee ... who has been directly and adversely affected by a decision of the Secretary...." 7 U.S.C.A. § 1983b (West 1988). See footnote 10 on page 11.6 for full text. This book makes the assumption that the "applicant" and "recipient" language refers to the farmer, not to the lender. The Sixth Circuit Court of Appeals made the opposite interpretation in *Parker v. Lyng* (see footnote 221 on page 15.55).

[225] 7 C.F.R. § 1980.80.

[226] See footnote 24 on page 15.55.

If Your Lender Is the FDIC

If your bank failed and the Federal Deposit Insurance Corporation (FDIC) holds your loan, your situation may seem very confusing. Another book in this series, *Farmers' Guide to FDIC,* can help you to understand how the FDIC operates. (See the publications list at Appendix C for information about how to order the FDIC book.)

The important thing to remember is that if the FDIC holds your loan, the FDIC is the *lender.* All of the guaranteed loan regulations discussed in this chapter that apply to lenders apply to the FDIC, too.

☐ FDIC May Try to Liquidate Your Guaranteed Loan

All of the rules about loan servicing and about what is supposed to happen when you have trouble paying your loan apply to the FDIC in the same way that they apply to other lenders. When the FDIC acquired your loan, it stepped into the shoes of your former lender. Remember that you have the right to:

- A meeting when you are in default,
- Consideration for loan servicing,
- FmHA's approval before liquidation, and
- Appeals of FmHA's decisions.

☐ FDIC May Try to Sell Your Loan

FDIC does not want to keep farmers' loans; it wants to get cash for the loans. If FDIC does not liquidate your loan, it will try to sell it.

If some lender or collection agency buys your loan, you will still have all of the rights described in this chapter. A new lender must agree to take on all of the responsibilities of the original lender.[227] Educate your new lender as described above.

FDIC often sells nonguaranteed loans to lenders that are located out of the farmer's home state. If the FDIC tries to do that with FmHA guaranteed loans, the FDIC must follow FmHA's "substitution of lender" regulations.[228] These regulations require that the loan be sold to an "eligible lender." A lender is "eligible" only if it has an office close enough to your farm to "properly and efficiently discharge its loan making and loan servicing responsibilities."[229]

[227] 54 Fed. Reg. 1565 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 180.122). There is some question as to what the consequences are if the lender refuses to carry out these responsibilities. Lenders will argue that they simply forfeit the right to collect on the guarantee. Farmers will argue that they are third-party beneficiaries of the contract between the lender and FmHA, and that therefore the lender's breach of its duties gives the farmer defenses to foreclosure or grounds for other legal actions. See Parker v. Lyng, which supports the lender's argument (see footnote 221 on page 15.55).

[228] 54 Fed. Reg. 1565 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.122); 54 Fed. Reg. 1548 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.13(c)).

[229] 7 C.F.R. § 1980.13(b)(3).

☐ Try to Get FDIC to Write Down Your Loan

Educate your FDIC loan officer. Explain to him/her how FDIC can write down your loan and get paid for the loss (90 percent of the write-down). Then you can try to get outside financing to buy out the written-down loan.

Show a copy of this chapter to your FDIC loan officer. (Also, you could order a copy of the shorter article on guaranteed loans. See the publications list at Appendix C.)

☐ Look for a Local Lender That Will Buy Your Loan

FDIC can be very difficult to deal with. The sooner your loan is out of FDIC's hands, the better it is for you. You may be able to speed up the sale of your loan by contacting local lenders yourself. Ask them to contact FDIC to try to purchase your loan.

In some situations you may be eligible to get an FmHA direct loan to buy out your guaranteed loan. (See discussion beginning on page 15.13.)

The Demonstration Project[230]

☐ The Basics

The Agricultural Credit Act of 1987 (the "Act")[231] requires FmHA to set up a program to encourage farmers to *buy Farm Credit System inventory land using FmHA guaranteed loans.*[232] The program is called the demonstration project. It will last for three years.[233]

The demonstration project applies only to inventory land held by FCS institutions that are ***certified*** to receive assistance.[234] As of March 1989, these institutions are the Farm Credit Banks of St. Paul, Omaha, and Louisville.[235]

On January 13, 1989, FmHA issued regulations that describe how FmHA will carry out its obligations under the demonstration project.[236]

[230] This section is taken from an article written by Anne F. Scott and Randi Ilyse Roth. It appeared in *Farmers' Legal Action Report*, Vol. 4, No. 1 (1989). Individual copies are available from FLAG. See the publications list at Appendix C.

[231] Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 1717 (1988) (codified at 7 U.S.C. § 1999(h) (1988)).

[232] 7 U.S.C.A. § 1999(h).

[233] The demonstration project began on January 6, 1988, and will continue until January 6, 1991. 7 U.S.C.A. § 1999(h)(1).

[234] Certain FCS institutions are *certified* to receive assistance and to issue preferred stock. For a detailed explanation, see "Farm Credit System: Structure and Financing Under the New Act," *Farmers' Legal Action Report*, Special Report, Vol. 3, No. 1 (1988), p. 52.

[235] The Jackson District is in receivership, but technically it is not certified.

[236] 54 Fed. Reg. 1594-96 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E).

☐ Interest Rate Reduction Under the Demonstration Project

If you buy FCS inventory land using an FmHA guaranteed *demonstration project* loan, your interest rate will be 4 percent less than the rate that your lender would ordinarily charge.[237] FmHA will pay for that 4 percent reduction.[238] FmHA will pay the reduced interest on a demonstration project loan for the outstanding term of the loan or for five years, whichever is less.[239] Note that this interest rate reduction program is different from the interest rate buydown program explained beginning on page 15.30.

FmHA will guarantee the repayment of 90 percent of the amount owed for loans that have this 4 percent interest rate reduction.[240]

Lenders of demonstration project loans may opt to *permanently* reduce the interest rate by one full additional percentage point; if they give you this permanent 1 percent additional reduction, they will receive a *95 percent* repayment guarantee from FmHA.[241]

	Interest Rate Reduction			
	Interest Rate Reduction	**Reduction is Paid for By**	**How Long Does the Reduction Last?**	**Percent of FmHA Guarantee on Loan**
The Basic Program	4%	FmHA	5 years or life of the loan, whichever is less	90%
The Basic Program Plus the 1% Permanent Reduction	5%	4% by FmHA 1% by the Lender	4% lasts 5 years or life of loan, whichever is less 1% is permanent—lasts for life of loan	95%

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237 54 Fed. Reg. 1595 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, § IV.F).
238 54 Fed. Reg. 1594 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, §§ II and IV.F).
239 54 Fed. Reg. 1594 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, § IV.I).
240 54 Fed. Reg. 1594 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, § IV.G).
241 54 Fed. Reg. 1594 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, §§ II and IV.H).

☐ Eligibility

To buy land through the demonstration project, you must get a **certificate of eligibility** from FmHA. This certificate says that you meet FmHA's criteria to get a guaranteed loan under this program.

Before FmHA issues the certificate of eligibility, the county committee must find that:[242]

A. You are eligible for an ordinary FmHA guaranteed FO loan;[243]

B. The farm is a family farm as described in FmHA regulations;[244] and

C. You are eligible for an interest rate reduction. This means:

- You must need the reduction to achieve a positive cash flow. To show a positive cash flow for a demonstration project loan, you only need to show that you can cover your debts and expenses.[245] You do not need to show a reserve. (See chart on page 15.27.)
- You must show that you will have a positive cash flow during the interest rate reduction period.[246]
- If the loan repayment period will continue after the buydown ends, you must show that you will have positive cash flow after the reduction period expires.[247]

☐ Right of First Refusal

When you make an offer to buy FCS inventory land through this program, the land may be subject to the prior owner's right of first refusal.[248]

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[242] 54 Fed. Reg. 1595 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, § III.B).

[243] The requirements for an individual can be found at 54 Fed. Reg. 1576 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(b)(1)). For the eligibility of a cooperative, corporation, partnership, or joint tenancy, see 54 Fed. Reg. 1576 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.180(b)(2)).

[244] 54 Fed. Reg. 1595 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, § III.B(2)). The definition of "family farm" for guaranteed loans is found at 54 Fed. Reg. 1559 (Jan. 13, 1989) (to be codified at 7 C.F.R. § 1980.106(b)(7)).

[245] 54 Fed. Reg. 1595 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, § IV.A).

[246] 54 Fed. Reg. 1595 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, § IV.J).

[247] 54 Fed. Reg. 1595 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, § IV.J).

[248] FmHA Instruction 2000-MM, Exhibit A, page 2, "Memorandum of Understanding Between the Farm Credit Administration and the Farmers Home Administration Regarding the Demonstration Project for the Purchase of Farm Credit System Land." For an explanation of the federal right of first refusal, see "Farm Credit System: New Borrower Protections," *Farmers' Legal Action Report*, Special Report, January/February 1988 (Vol. 3, No. 1), at page 45.

☐ Fifteen-Percent Down Payment

You must make a down payment of 15 percent of the purchase price from your personal funds.[249] FmHA defines "personal funds" as "any funds listed on a borrower's financial statement or obtained through a loan, whether or not secured by other property."[250]

This 15 percent down payment requirement will make it very hard for many farmers to use this program.

☐ Conservation Requirements

You must meet all conservation requirements that are imposed on borrowers of ordinary FmHA guaranteed farm ownership loans.[251]

FmHA guaranteed loan money cannot be used for any purpose that will:

- Contribute to excessive erosion of highly erodible land, or
- Contribute to conversion of wetlands to produce an agricultural commodity.[252]

You will also have to meet other USDA conservation requirements.[253]

[249] 54 Fed. Reg. 1595 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, § IV.C).

[250] 54 Fed. Reg. 1595 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit E, § III.D).

[251] Borrowers must meet the requirements of 7 C.F.R. Part 1940, Subpart G. See 54 Fed. Reg. 1595 (Jan. 13, 1989) (to be codified at 7 C.F.R. Part 1980, Subpart B, Exhibit F, § IV.D). Among other requirements, the borrower must provide SCS Form CPA-26, "Highly Erodible Land and Wetland Conservation Determination," and Form AD-1026, "Highly Erodible Land and Wetland Conservation Certification," as required by 7 C.F.R. Part 1940, Subpart G, Exhibit M.

[252] Form AD-1026, "Highly Erodible Land and Wetland Conservation Certification," 7 C.F.R. Part 1940, Subpart G, Exhibit M, § 3.

[253] See Form AD-1026, "Highly Erodible Land and Wetland Conservation Certification," 7 C.F.R. Part 1940, Subpart G, Exhibit M, § 4, which provides: "Should a farmer program applicant rely or plan to rely on any ... other USDA financial assistance programs as a source of funds to repay its FmHA loan(s) and then fail to meet the other program(s) eligibility criteria related to wetland or highly erodible land conservation, repayment ability to FmHA or the lender of an FmHA guaranteed loan may be jeopardized. Consequently, those applicants who are applying for a loan and those borrowers who receive a loan ... and who include in their projected sources of repayment, potential funds from any USDA program ... will have to demonstrate as part of their applications, and for borrowers, as part of their farm plan of operation, their ability to meet the other program(s)' [conservation] eligibility criteria."

Secondary Mortgage Market for Guaranteed Loans

The Agricultural Credit Act of 1987 ("the Act") created a corporation whose job is to foster a "secondary mortgage market" for agricultural loans. That corporation is called "Farmer Mac."[254] The Act also created a *separate* secondary mortgage market for FmHA guaranteed loans.[255] This section will discuss that separate FmHA secondary mortgage market.

There has always been some secondary mortgage market activity in FmHA guaranteed loans.[256] The Act promotes and encourages the expansion of this market.

The basic steps in this secondary mortgage market process are:

- The *farmer* gets an FmHA guaranteed loan from the *lender.*
- The lender can sell the guaranteed portion of the loan to a *holder.* The lender continues to service the loan.
- The portion of the loan that was bought by the holder can be *pooled.* The Secretary of Agriculture can pool the loans directly, or the Secretary can pool them through an entity called a *market-maker.*
- *Pool certificates* representing ownership interests in the guaranteed portions of the pooled loans can be issued to investors.
- The Secretary of Agriculture can *guarantee* that the principal and interest on the pool certificates will be paid on time.

The regulations for this secondary mortgage market program were supposed to be issued by July 5, 1988.[257] FmHA stated in January 1989 that regulations would be issued "in the near future."[258] As of May 25, 1989, FmHA still had not issued regulations .[259]

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[254] For a detailed explanation of how "Farmer Mac" works, see "The Secondary Mortgage Market: An Introduction to Farmer Mac," *Farmers' Legal Action Report*, Vol. 3, No. 1 (1988), p. 98.

[255] 7 U.S.C. § 1988(f) (1988).

[256] 7 C.F.R. § 1980.62.

[257] 7 U.S.C.A. § 1988, note ("Final Implementing Regulations") (West 1988).

[258] Prefatory comments, 54 Fed. Reg. 1547 (Jan. 13, 1989).

[259] See *Agri-News* (May 25, 1989), at 3.

Senator **Conrad**. Thank you very much. Excellent testimony by everyone on this panel and we appreciate it very much. Let me, Sox, ask you, we have heard testimony from GAO and we have seen in the Inspector General's report that only 2 percent of the guarantees are going to borrowers other than existing borrowers of commercial banks. I think the Inspector General's report shows 1 percent. Since the whole notion is that we are supposed to be graduating people from direct to guarantees, and that guaranteed loans are supposed to be used to make it possible for new borrowers to graduate, what is your assessment of why this is not working?

Mr. **Johnson**. I think the fact that we had so many borrowers that were under stress for so many years, our people were simply spending what time they had in trying to save those borrowers to comply with all of our regulations, including the Agricultural Credit Act of 1987. I think that is a big part of it. Certainly other lenders were stressed, so they were looking for a home, and they were looking to Farmers Home to come with a guarantee. I do not think there is any question about that. So I think it is merely a matter that the lenders were looking at other lenders who were looking to their portfolio to clean it up first. At the same time, we were trying to clean up our most stressed borrowers in our portfolio in working through the Agricultural Credit Act of 1987.

However, as we indicated at the last meeting, Senator, we feel that we have something in the magnitude of 9,000 or 10,000 farm borrowers in our portfolio that we would rate as commercial rating that lenders, private sector lenders, should be able to take——

Senator **Conrad**. 9,000 or 10,000 out of how many?

Mr. **Johnson**. We are about 213,000. We are in that range now, Jack? OK, 203,000 direct loan borrowers. So roughly 10,000 and that is what we are looking at. We have identified those 10,000 borrowers, and we expect to devote the time now that we are working on through the Agricultural Credit Act of 1987. So our people can devote some time to both our healthy borrowers, as well as our stressed borrowers.

Senator **Conrad**. Let me ask a followup, Sox, because the numbers you have just provided raise a question. You have 200,000 direct borrowers, 10,000 of those you see as commercially viable, and yet the President's budget says cut direct lending in half. How does this all add up? You have 5 percent of your direct loan borrowers who are commercially viable and yet the President's budget says cut direct lending in half. How does this all add up?

Mr. **Johnson**. We really have more than 10,000—when you look at our guaranteed program and as we are proposing who we would serve with our program, with our farm credit bill program, what we are proposing to do—we have a lot of other borrowers with our interest buy-down that we are proposing could also shift to the guaranteed in addition. We are saying that 10,000 bankers should be prepared to take those without any extra incentive from Farmers Home, and we feel that a number, probably I would say, we have—what, 40,000 to 50,000—that are classified fully satisfactory mode that could potentially, with a write-down, be a candidate to also convert to the guaranteed loan.

And then, of course, we have the substandard group which is the group that we expect to work with. We have run numbers and our estimates indicate that the budget requests we have—obviously, we are not here today to go through our budget hearing, but it does interrelate with our farm bill presentations and so forth. We feel that our budget requests are tight as we would expect them to be, our request for programs, but we also believe in the statement that I said here, no one is going to fall through the cracks. We believe we have a program to take care of those worthy candidates.

Senator CONRAD. Sox, I respect your sincerity in saying that, but I tell you in the hearings that I held in North Dakota, nobody agreed with that. I mean not a single person, including your State FmHA director, agreed with that. Your State FmHA director testified that there is no way that all of those people who would not be able to get direct loans with this kind of cut back could get private credit. So I say to you with great respect, I do not believe that no one falls through the cracks.

We have gone from $4 billion in direct lending in the early 1980's down to $1 billion last year and now the proposal is to cut that amount in half. I look at this GAO report and what they are hearing from bankers is look, we do not want to take all those folks. We do not want to take them. They are not creditworthy by our standards and they are too risky. We are not going to pick up those people.

I asked the bankers at home, are you going to take all these folks? They said no. I said if this proposal were implemented—I asked the private bankers now—can you tell me that no one is going to fall through the cracks and that people who ought to have credit available to them are going to find a home with private borrowers? No. They said absolutely not. There is no way we can take this big a change in direct loan funding.

We see the GAO report [10] which says only 2 percent and the Inspector General's report says only 1 percent of direct loan borrowers are moving over to guaranteed loans. I just have to wonder about the wisdom of trying to bite this all off in a year. Are we really going to do the job that you suggest can be done? I will add another factor to you. I do not know where this time to assist direct borrowers to get guaranteed loans is going to come from with your staff. One of the things we talked about in North Dakota was the staffing situation. Staff are overburdened because they are still in the midst of handling all of the work from the Agricultural Credit Act.

I must say, I commend you for the effort that is being made on restructuring. I think it is a tremendous effort to clear the chaff out from what came before. You and your people are doing a terrific job out there working through this problem. But I really wonder in the midst of all that are there adequate staff resources to try to bite off this project? I would be happy to——

Mr. JOHNSON. Of course, you are giving me a lot of latitude of points to discuss there that you raise in your conversations. Obviously, I guess, if you ask me as you possibly asked other lenders, do they think we can absorb this quickly, I would probably say no. OK, it wouldn't be easy. But our program is not that we are going to do it within 1 year. Our program is we are going to work through. We say, we maintain that we have adequate funds and we are requesting enough funds this year that people will not drop through the cracks. And we monitor this, as I indicated before here just a week or so ago, we monitor this daily, where we are in the use of our funds. We find right now on direct operating loan, we are 65 percent of the funds that we used at this same date a year ago. North Dakota, I thought it was interesting, has only used 32 percent of the funds that they had used on this date a year ago. And at the guaranteed lending, we are in the roughly 90 percent of where we were, so we are down in both. But we are down substantially more—40 percent—in direct loans.

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[10] Farmers Home Administration, Implications of the Shift From Direct to Guaranteed Farm Loans, GAO/RCED-89-86, GAO, September 1989.

So these are the kinds of projections that we are making as we have tracked in for the past several years and see the use of funds. We are not seeing a significant decline in the amount of the loan yet, but we do feel that we are making progress, that people are not asking for funds that they certainly do not need and do not feel that they can repay, as we all suspect has happened many times in the past in which we have granted them funds.

So we see with the entire program, you do have to look at ours over a program, that you are telling these borrowers, hey, our farm bill proposes, the administration's farm bill proposes, gives us 7 years in a direct loan program, 3 more years in a guaranteed program, if needed. It could be rescheduled at the end of that, a potential of staying with us 17 years. We see that as adequate time for us to do our job and do the supervision necessary to make this transition.

So, Senator, I have more than just my sincerity and belief that this can happen. It will if we all work together. Certainly I am not saying it will be 100 percent. There may be a few people dropped through the crack, but that is always going to happen to us.

Senator **Conrad**. Let me just say to you that I hate to interrupt, but we have 7½ minutes left in a vote. So we will recess and we will be right back. If you can all remain, we would certainly appreciate that.

[Recess.]

Senator **Conrad**. We are just reconvening and we were just at the part where Sox Johnson was agreeing with my view—was that not what was happening? Was my recollection somewhat incorrect?

Mr. **Johnson**. Not too much, Mr. Chairman.

Senator **Conrad**. Maybe if I can just restate more briefly what it is that most concerns me. We get testimony from GAO and the Inspector General's report that tells us a tiny percentage of people are moving from direct to guarantees, and we get a proposal from the administration to cut direct loans in half when they are oversubscribed and guarantees are in 1989 only running at 35 percent of authorization.

Do not those set of facts tell us that there is a problem with the underlying premise that we move even more dramatically to guarantees?

Mr. **Johnson**. No, sir, on the direct, we were talking as you were out of here and I was reminded that we made about 22,000 loans, direct operating loans, last year. So I note from some of the numbers you were apparently trying to run there a little earlier, you were thinking that if we shifted 10,000, we were not going to be able to service the number of people.

But when you consider the number of loans that we are actually making to those of direct, I believe you will find that if we are successful in shifting 10,000 of our portfolio this year to guaranteed, we will certainly be able, and we think we are on target in shifting to the guarantee with what funds we have available to meet the needs of all of those borrowers with both direct and the guaranteed funds on operating purposes.

Senator CONRAD. Let us go back over the numbers and make sure we are not talking past each other, that I have not misunderstood. You have 200,000 loans in your portfolio, am I right?

Mr. JOHNSON. In that direct portfolio.

Senator CONRAD. Direct loan portfolio. That is direct operating and direct Farm Ownership loans?

Mr. JOHNSON. No, that is borrowers.

Senator CONRAD. 200,000 borrowers?

Mr. JOHNSON. Yes, that have borrowed money from us some time in the past, but are still on the books with us.

Senator CONRAD. That would be 200,000 of every type—guaranteed, direct?

Mr. JOHNSON. No, that is just direct—ownership or operating.

Senator CONRAD. When you talk about shifting 10,000 from direct to guarantees, you are talking about 10,000 out of 200,000?

Mr. JOHNSON. That is correct—roughly 5 percent.

Senator CONRAD. I did understand then. Let us go back to the other witnesses and see if they would like to react. GAO.

Mr. HARMAN. I wish I could be as optimistic as Mr. Johnson is, but just looking at history——

Senator CONRAD. Sox is from Texas, you know. You know where we had all the S&L trouble. [Laughter.]

These guys, they all have big hats down there.

Mr. HARMAN. I wish I could be as optimistic as Sox is, but based on the work we have done in the past, and that is all we have to go on at this point, and I am relying to some extent on some work we are doing for the chairman of the full committee on the implementation of the Agricultural Credit Act, I would charitably say we are doubtful about it. And I could let maybe Harold make any comments he would like to make based on his discussion with lenders.

But one thing we did and this has been some time ago. This was in 1985–1986, we looked at the graduation problem. We identified 1,900 borrowers that we wanted to look at and see if could they graduate, could they go to commercial credit. We identified 19 out of those 1,900 we thought were the cream of the crop, and we went to—I forget how many, but it was somewhere in the neighborhood of 30 lenders, 20 or 30 lenders, and they would take none of them.

Now a lot has changed since then.

Senator CONRAD. In my part of the country, it has gotten worse.

Mr. HARMAN. In some parts of the country, it has. But on the other hand, there is the interest rate reduction program. There is the proposal for more generous interest rate in a new interest subsidy program. We have no way of knowing at this point what impact that will have on a shift to loan guarantees. But many of these borrowers, and if they are in fairly good cash-flow position, it would seem like the banks could take them. And we have not looked at these 9,000 borrowers that Sox is talking about. But if they are in a good cash-flow position, they could take them. But that would in effect double the amount of guaranteed loans or almost double the amount of guaranteed loans from what they have loaned this year.

Senator CONRAD. John, let me ask you this. The interest rate reduction program—what is the name that we are giving that program?

Mr. JOHNSON. Interest Assistance Program. We are staying away from terms like subsidies and those types of things.

Senator CONRAD. In 1988, I think, only 10 percent of what was authorized for the interest rate reduction program was used. Am I right?

Mr. JOHNSON. Something in that range. I believe she said 13 percent.

Mr. HARMAN. Overall for the 3-year period that it has been in existence—a little over a 3-year period, it has been about 13 percent.

Senator CONRAD. That is for a multiyear period?

Mr. HARMAN. That was for 1986 through 1989.

Senator CONRAD. I read the GAO report. The report is saying we are just not getting the kind of participation you would like because very frankly, the lenders do not want this group of borrowers very badly, even with an interest rate reduction. What is it, Sox, that convinces you that there is going to be some dramatic transformation?

Mr. JOHNSON. The availability of direct loan money in the first place, the lenders, and as I think they testified here today, they would like very much for us to keep a very active, viable, direct loan program. With such, we could certainly carry this higher risk group of people that we are trying to define who we are to serve. So they see us taking those.

It is a lot better for them, if it is a clean deal, if it is a risky or marginal person, to just say OK, Farmers Home is a lender of last resort and you go there, because we as a bank do not want to be a lender of last resort. If I was that banker, I would take that position, as well, just as you heard them testify here today. So they would like for Farmers Home, I think, to stay in that strong, direct lending role.

We have found that the success with our guarantee program has worked, as we have had reductions in the available direct loan funds, as we have kind of squeezed that down, we have found that our people get with the program to make the guaranteed lending program work. We have seen it happen in State after State. Jack was showing me some numbers here earlier.

Just 3 years ago, with several of our big users that I mentioned earlier, they were using—like in 1985 they were using 2—I am talking about Mississippi, Arkansas, Georgia, and Louisiana. All of those were among the big users I mentioned. In 1985 they were running 2 to 6 percent of their portfolio was guaranteed. By 1990 they were running 60, 82, 65, 93 percent.

Senator CONRAD. In 1989, nationwide, of the authorization that you had for guarantees, how much was used?

Mr. JOHNSON. Something over 50 percent, didn't we?

Mr. HERTZLER. Fifty percent of the loans made.

Senator CONRAD. But as I understand it, you only used 35 percent of the authorization in 1989?

Mr. JOHNSON. In dollars. Speaking in dollars, that is correct.

Senator CONRAD. Does that not tell us something? What does it tell you?

Mr. JOHNSON. We did not run out of direct operating money last year, even though we got an additional $32.5 billion. So we had adequate direct operating funds. It says the demand is down.

Senator CONRAD. I might say that the allocation system is not working. Do you keep records on how many people inquire about direct loans that your people discourage?

Mr. JOHNSON. Yes, that make applications for loan? Yes.

Senator CONRAD. No, no. You have people that do not even apply, who come and say we would like to get a direct loan, and who are discouraged from even applying.

Mr. JOHNSON. Obviously, we would not have a record such as that.

Senator CONRAD. That is happening. That is happening. Absolutely. I hear that. I go out in the countryside. I just came back from 11 cities in my State, doing farm forums and a hearing on the Ag Credit Act. You know what I hear at every place? Why is it that all these farmers and bankers are standing up and saying this is a mistake. We are not using all the guaranteed loan money. We are not using anywhere close to all of it. We are oversubscribed on direct loans, and this Interest Assistance Program is going to help, but it is not going to solve the problem.

You are going to have a real misfit between people who are in the direct program now and are going to be denied direct loans but cannot get a guaranteed loan. You guys are going to have a big mess out here.

I have had 3,000 farmers come to meetings in the last week, and this is what I hear at every single meeting. It does not inspire a lot of confidence in me.

Then I look at these numbers. We have 2 percent in one study that have gone from direct to guarantee, 1 percent in the other. You are a great salesman, Sox. I will tell you, if I have any stock I want to sell, I am going to get you on the board of directors.

Then I look at the interest rate buydown program, of which only 10 percent of the authorization is being used, and I really wonder are we kidding ourselves?

Mr. HARMAN. Let me make one comment, Mr. Chairman, about that. We found the use of the direct loan program has declined substantially during the 1980's. What we found, one reason for that, is the way USDA paid farmers their deficiency payments. They went to advance deficiency payments, so they got more money out there to farmers during the planting season.

We have had some substantial payments in disaster assistance, which could be another reason why the demand for both of those programs is not up now for the direct program, and has not been there for the loan guarantee program.

So it seems to me we are talking about what do we do with these direct borrowers and how fast do we do it, that we currently have on the books, that are marginal? Do we try to force them into loan guarantees? Do we continue to write them down? That gets really back to the subject of the last hearing we had, dealing with the role and the mission and what should this agency be.

Senator CONRAD. Ms. Roth, I have not given you a chance. Do you want to riddle Sox's testimony?

Ms. ROTH. I have just a few comments. I would like to make four categories of comments. The first is, Senator Conrad, to your overall question of how does this all add up, the way it seems to me, based on my experience, is it adds up to massive loss of farms. I cannot see any other result, if we essentially eliminate the direct loan program and put more money into the guarantee loan program. There are large categories of people for whom the guarantee loan program simply will not work, is my experience.

The second set of comments I would like to make are about this topic of whether we are running out of direct operating loan money. I was surprised to hear FmHA testify that we, in fact, did not run out of operating money last year, because almost everyone who I talked to said well, I put in an application but there was no money. So in all the areas that I worked in, I was hearing that.

Now, I do not doubt what Mr. Johnson says, but when you said maybe it has something to do with the allocation system, that rings true to me, because a great number of farmers are reporting that money was just not there.

The other comment I would make about operating loan money unavailability is that one program with operating loans in the last couple of years has been that the continuation policy, which was the statute that authorized it, was passed by Congress but it was not implemented properly. The regulations were very late. When the regulations were implemented, they contained several improper eligibility criteria that made it impossible to get loans from that program in most cases.

We corresponded with the agency at length over that and finally, I forget the date, new regulations came out implementing it properly. But it was very late and it was after, I believe, the last operating season that that happened. So delinquent borrowers were unable to obtain assistance through the continuation loan policy, contrary to Congress' express intent.

Senator CONRAD. I can tell you, Sox, that in North Dakota, I am hearing even now that people are being discouraged from getting direct loans.

Mr. JOHNSON. I would expect our people to discourage them if they felt they had a good opportunity to convert to private sector, but our people should be going with them to that. Otherwise, obviously we are always interested. We hear these kinds of statements all the time, and we follow up. In fact, I sometimes talk to farmers myself, that call and get me directly, and they say, hey, the County Supervisors says we are out of funds, and I say that is absolutely not so and you go back and tell him I told you so. Then I try to check it out.

Senator CONRAD. To further this communications process, what we did, the Congressmen and I, when we were around North Dakota, and met with these 3,000 farmers, was we gave them your home phone.

Mr. JOHNSON. We have a wrong number on the recording.

Senator CONRAD. Borrowers do not choose to be FmHA borrowers. They have to be turned down for credit elsewhere. That is the policy. They have to be turned down twice to get a direct loan. So again, I really question whether we are in a position to do what is being suggested.

Let me ask about the loss situation. Sox, in your testimony, as I read it, you are indicating we are getting a reduction in delinquencies. Let me ask GAO, do you agree with that? Are we getting a reduction in delinquencies? What is happening to delinquencies and losses?

Mr. HARMAN. We define delinquencies a little different than what Farmers Home does. I think you, Sox, talked about a 1-plus percent delinquency. In our testimony, we have a table that shows about a 6 percent delinquency rate. Farmers Home, as we understand it, counts delinquent payments. What we do is normally what the bank will do. That is, once a payment is delinquent, the whole principal is considered delinquent. So that is the reason for the difference in that percentage.

I would expect delinquencies to be much lower under the guarantee program than under the direct loan program. For one thing, the direct loan program has been in trouble for some time. Also, usually, once you get a delinquent situation in the loan guarantee program, you are going to usually have some action on the part of the institution, the lending institution, as well as maybe perhaps Farmers Home to do something about that delinquency in a much shorter period of time than happens in the direct loan program, and it will result in some sort of liquidation.

So that delinquency rate, I do not think it is quite fair to compare the two delinquency rates between the direct loan program and the guarantee loan program.

Senator CONRAD. It is a totally different pool of borrowers, as well, right? Obviously, your direct loan people are the least creditworthy. Your guaranteed loan borrowers, by definition, are going to be people that you can move over into private sector banking.

Mr. HARMAN. As an example, I think it was 67 or so sample borrowers that we looked at as part of our loan guarantee work, we found that about half of those people were below a 70 percent debt-to-asset ratio. The average was somewhere in the neighborhood of 76 percent. I do not think that is typical of what you would find with a direct borrower.

Senator CONRAD. Remind me of the numbers that you gave, John, when you went out and looked at 1,900 accounts. You picked out the 19 best borrowers and then you went to 20 or 30 financial institutions and they would not pick those borrowers up?

Mr. HARMAN. They would not pick those up. Of course, at that period of time, that was in the middle of the farm crisis, 1985, 1986, and I think we did the work in 1987. It concerned borrowers in that period. At that point, agricultural banks were not too excited about doing a whole lot.

Mr. JOHNSON. How about the interest buydown? Were you talking to them in terms of an interest rate?

Mr. HARMAN. No, at that point in time, the interest rate reduction program was just underway, so we were not able to.

Senator CONRAD. I tell you, Sox, the testimony I got at home was very clear. The interest rate buydown would help and they would like to move more into guarantees, but they just do not think it is sustainable to have the kind of dramatic cuts on the direct that is being called for. They do not think that it will work, and that we ought to try it on some experimental basis and see what kind of movement we get before we tie our wagon to that star.

Mr. HUNT. Mr. Chairman, I would like to add a couple of things.

Senator CONRAD. Identify yourself for the record.

Mr. HUNT. My name is John Hunt and I am an Assistant Director with GAO.

Cash-flow is a big problem here. I think what we are talking about is the possibility of some direct borrowers switching to a guarantee program with this new interest subsidy, this interest assistance program that FmHA has come up with in its proposal, to get the borrowers to cash-flow.

This is a risky loan for a private lender because what that is saying, in effect, is income projected out will equal projected out expenses. Technically, if a tire blows, something happens, that person is out of business. The lender is going to have to make a decision on that. Is that an acceptable risk?

From the work that we have done on the guarantee program in the past, that has not been an acceptable risk for the lender. They are looking for increased security. They are looking for a better debt-to-asset ratio. And they are looking for a higher cash-flow. So I think that is, I guess, a premise that is being based here that we question.

Senator CONRAD. Sox, do you want to respond to Mr. Hunt's comment, that you go out and talk to the bankers about guaranteeing a loan and they say hey, the cash-flow is marginal?

Mr. JOHNSON. I think that is something a little different from what we heard these bankers, that testified here today, because at least one of them was suggesting that we reduce that 110 percent cash-flow requirement. We think it is paramount that we have it. I wish we had it on direct loans.

We need to get to that point, so we are dealing with borrowers that have that type of credit quality, so they can—when they have that blowout on that tractor—be able to get that tire fixed without having to get into a serious problem and come back to us.

Mr. HUNT. I think on the cash-flow requirement, that was mentioned by the representative from ABA, you would have to get what is their definition of what that means. They are saying it would be something less than 110 percent. Under FmHA, that does not include contingencies or equipment replacement of any kind, whatsoever. Under his cash-flow requirement, it may.

So I think you would have to get into a definition of what those two things are.

Senator CONRAD. We talked about that very thing. I will tell you, one of the great concerns out across my part of the farm country is what are we going to do about replacing equipment. People have not been buying equipment for 10 years. What are we going to do? Where is the money for the new equipment going to come from, number one?

Number two, I wish you could have been with me at these farm meetings. The average age of these farmers is 55 or 60 years old. We had a joke at the hearing in Bismarck. One of these guys says I am advanced middle aged. Everybody who testified is advanced middle aged. You come to these meetings and they are all advanced middle aged.

They are saying, where is the credit going to come from to allow a new generation to take over? And where is the credit going to come from to buy machinery when we have been living off the balance sheet here for 10 years?

That is a question I hear.

Mr. **Johnson**. In our proposal, as you know, is that the private sector will provide that credit with some incentive programs, Government related incentive programs such as we have suggested in our farm bill proposal. We recognize the need.

Senator **Conrad**. Let me ask you this, Sox, because this is very important with respect to, I think, both the Office of Inspector General and the GAO report [11] on loan processing and servicing. Both of them found what they described as serious guaranteed loanmaking and oversight problems which, if not corrected, will lead to serious delinquencies and ultimately losses in those programs.

Have you had a chance to review those reports with respect to loanmaking and oversight problems that they identified?

Mr. **Johnson**. It is not ringing a bell with me. I am not sure.

Senator **Conrad**. Anybody from GAO?

Mr. **Harman**. That was the loan guarantee report that we just issued back in September of 1989.

Senator **Conrad**. Do you want to comment on what you found that caused concern?

Mr. **Harman**. We found basically four things. One, we found a poor assessment of repayment ability. These were all confirmed by work that the OIG had done, very similar to what we were finding in the direct loan program. In other words, the repayment ability of the people getting these loans was not adequately determined, as a result, it was resulting in losses.

Insufficient determination of collateral value, particularly with regard to debt-to-asset ratios, and the use of crops as collateral. A lot of them did not have any insurance, crop insurance, covering those crops, so we saw insufficient collateral value.

Unclear guidance on the percentage of guarantee. I have heard some comments about that today. The maximum percentage guarantee is 90 percent. Some places we found that the county offices were giving the 90 percent guarantee if there was high risk. In other places, they were attaching it to a low risk. So they were doing different things with it.

Oversight after the approval, and that dealt with obtaining periodic financial statements. This has to do with overseeing the financial institutions and how they carry out their responsibilities toward these lenders, as well as making unauthorized loan advances and then paying those advances as part of the guarantee, and untimely default notices, which impact both on Farmers

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[11] Farmers Home Administration, Implications of the Shift From Direct to Guaranteed Farm Loans, GAO/RCED-89-86, GAO, September 1989.

Home's ability to collect any losses that they may incur, as well as the individual borrower, in knowing when they are in default and what is happening.

Then not pursuing loans after they have been liquidated. There were some problems there, also.

Senator CONRAD. How are we going to fix up this disaster in the guarantee program?

Mr. JOHNSON. We are going to devote more time to it than we have, hopefully because we are going to get through with the Agricultural Credit Act one of these days and be able to devote the extended time.

But we are looking and putting into place a number of systems, including automated systems, as a part of our credit management oversight and review. We now have regular monthly meetings of our top staff, and we started this a few months ago, both to look at credit management and also from general management. So we are looking at these.

Obviously, credit quality gets right back to—you know, if you strike the 110 percent, you are hurting for credit quality. We think we need those. We need to strengthen credit quality. We recognize there is a limit that we can go on that one, but we too are interested in credit quality, as you heard me mention a number of times.

Collateral, we are making extensive use of an internal control system that we have, coordinated assessment reviews, that we do out of the national office on States, in addition to having help from GAO and OIG and others that go out and look over our operations. So we are trying to get a handle on those things. We need more work, and we recognize this, in the rating of lenders, and the performance of lenders. We are working on some regulations.

That came up today. Some do not know the difference in approved lender and another lender, and we are looking at a certified lender. We recognize we have things to do in that area, but we see all of this coming kind of evolutionary, as opposed to revolutionary. Again, it is not going to all happen this year, but we feel that we know our problems and are making progress.

We do have better automated management information on these. Getting these periodic financial reports has been a life-long problem, as long as I have been associated with Farmers Home and guaranteed lending programs. People have difficulty getting financial information out of borrowers.

Senator CONRAD. Let me ask you a question and respond to points Ms. Roth made. She outlined, I thought very articulately, the problems that we are going to face on guaranteed loan servicing, the difference in guaranteed loan servicing requirements versus direct loan servicing, and the whole question of borrowers' rights that exist in the direct loan program that may not exist in the guaranteed program. What would your response be?

Mr. JOHNSON. Obviously, she goes much more for rights than I am personally comfortable with. I feel that we should all have the right to fail as well as the right to assure success. So I guess we come from a different premise.

Senator CONRAD. Congress passed those rights on a fully bipartisan basis in the Agricultural Credit Act and they said it applies. Assuming that Congress has not changed its mind, over in the direct loan program you have a pretty clear standard of when servicing must be provided and over in the guaranteed loan program, as she outlines, you have quite a different set of standards.

Mr. **JOHNSON**. It is a matter to what extent you are going to impose or regulate the private sector lenders. With us and Farmers Home, we are totally government, we are not quasi-government. We are totally government and so Congress can tell us what to do and that becomes a law and we follow through.

I do not know that, in our so-called free enterprise system, that you can never get to that extent in working with that private sector, that we would expect to impose upon an agency such as Farmers Home.

Certainly I do believe there are some reasonable rights that all of our people have, and I think that we should be cognizant of those and I think that we are, by and large, sharing that with lenders because once a lender or a borrower becomes delinquent, that lender contacts us almost without exception but he is certainly supposed to within 30 days, if they become delinquent. So we start an informal dialog with them, sharing with them the tools that we would have.

Senator **CONRAD**. Do you tell them?

Mr. **JOHNSON**. We do tell them. So I have been advised by my staff and I have asked that question. I have asked it some of our people. So I do know that we are telling them and lenders that deal with our program, they know pretty much what those rights are.

Senator **CONRAD**. Have you provided something in writing, Sox? Has the agency provided the banks that are providers of guaranteed credit with written information about what the borrowers' rights are?

Mr. **JOHNSON**. Certainly I do not expect that we have to the extent that we communicate with our own borrowers to inform them of all their rights. Jack, can you help me on this? Do you know of any?

Mr. **HERTZLER**. No, we do not have any specific communications.

Senator **CONRAD**. How many banks do guaranteed lending?

Mr. **JOHNSON**. How many banks are we doing guaranteed lending with?

Mr. **HERTZLER**. It is about 12,500.

Mr. **JOHNSON**. 12,500? That is both Farm Credit and commercial banks?

Mr. **HERTZLER**. That is all lenders.

Mr. **JOHNSON**. And farm program, about 80-something percent of all loans guaranteed now are guaranteed by commercial banks, as opposed to Farm Credit, is that right?

Senator **CONRAD**. How much?

Mr. **JOHNSON**. About 80 percent of the loans that we have.

Senator **CONRAD**. It sounded to me like Ms. Roth had a pretty good suggestion, in terms of providing them some basic information as to what borrowers' rights to servicing are.

Mr. **JOHNSON**. We will certainly look into that. Certainly, again, I would not go as far as she advocated, I do not think. I have already described our difference in philosophy on that.

Senator CONRAD. No, but I am limiting this now to a basic question about providing those people with information as to what the law provides right now?

Mr. JOHNSON. Some of the servicing tools that they could and should use.

Senator CONRAD. Right. It would seem to me to be a reasonable and prudent thing to provide that. Otherwise, there will probably be another lawsuit.

I see son of Coleman coming.

Mr. JOHNSON. Let us hope I am in Texas.

Senator CONRAD. Let me tell you that the other two Senators here were so overwhelmed by Ms. Roth, they told me that she is so smart, we are not going to go back and take her on.

Ms. ROTH. Senator, if I could add one more comment, in response to what Mr. Johnson said about a government versus private distinction. In the write-down program, in the guaranteed loans, that does not really hold up because all that the law says, the Agricultural Credit Act says, if the lender in his or her discretion would want to do a debt write-down and if the farmer meets all of the eligibility criteria, including the cash-flow criterion which said it is cheaper for the bank and the Government to do it, then FmHA approve the write-down.

So there is no imposition of anything on the lender, against the lender's will.

Senator CONRAD. It is voluntary.

Ms. ROTH. It is completely voluntary. So the private discretionary nature of the lending institution is completely preserved. The problem is that it has been a ghost program, in terms of FmHA's implementation of it, because there has been no notice, people do not know about it, and it is just not happening.

When you compared it to *Coleman,* in *Coleman* the issue was 7 U.S.C. section 1981(a) which says the Secretary may give deferrals and the Secretary then interpreted that to mean well, maybe we will and maybe we will not, and we are not going to. That is pretty close to what is happening with this write-down program. It is just not being implemented, period.

Mr. JOHNSON. Are you limiting your remarks to the write-down or are you referring to servicing in general? I thought we were talking about servicing in general.

Ms. ROTH. Those specific remarks were about write-down, that if the lender wants to do it and the numbers work, FmHA has to. Those provisions are in the write-down part of the Agricultural Credit Act.

But really the remarks apply to guaranteed loan servicing across the board because though you do have lender discretion in all those programs, and you have fairly complicated eligibility criteria in all those programs, and as far as I can tell, for the most part they are just not being implemented at all.

Like when I talk to farmers and they are at the end of the road and I say, let us go back. Did you have your meeting upon default, like the regs require? First of all, I would say at least 90 percent say no or they never heard of it. The ones who did have it, they say yes, but we did not do anything there.

I said, did they not sit down and discuss your eligibility for loan servicing and go through all the available tools and look at your cash-flow? I have never heard a yes to that.

I think partly it is a lack of knowledge. People do not understand that they are required by the lender's agreement to go through that analysis. There would have been a lawsuit by now if there were not the problems with a right to sue essentially on the part of farmers, so that to do the lawsuit we would either have to take on that issue, the whole right to sue issue, or represent a bank.

Senator CONRAD. I will tell you, I can just feel we have another lawsuit coming. It is just a matter of time, the right set of circumstances, and there will be a lawsuit on this one. So I think it would really behoove the agency to get out in front of this curve and take steps to make sure that those lenders know what is provided for in the law.

Mr. JOHNSON. And we will do that.

Mr. HUNT. Mr. Chairman, in response to the recommendations we made in our report in September of 1989, Farmers Home responded pretty favorably to the things we came up with. I think in the last hearing, they testified to the fact that our findings were generally accurate.

They are in the process now of doing a study, that they have contracted with a private accounting firm, of loan approval and borrower selection criteria. That study is scheduled for completion this May.

In addressing our recommendations, they put a lot on that study and the results of that study. It gets down to the percentage of guarantee, what should that be, what should it not be. It gets down to the adequacy of security, what should it be, what should it not be.

So I think that may address a lot of things, and I think some questions to Farmers Home, as to what is the status of that study at this point in time may give a little bit more information as to where this is going.

Mr. HERTZLER. It is on schedule and we expect to have it completed by about May.

Senator CONRAD. Let me ask you this. You have what, about $22 billion in the FmHA's loan portfolio?

Mr. JOHNSON. I thought it was $25 or $26 billion.

Mr. HARMAN. Including guarantees, about $27 billion.

Mr. JOHNSON. Farm program you are referring to?

Senator CONRAD. Yes. $27 billion in guaranteed loans. Roughly half of that is delinquent? A little less than that.

Mr. HARMAN. I think you have to maybe separate those two. There is about $23 billion, I believe, is about what the direct is. And about half of the $23 billion is delinquent.

Senator CONRAD. $23½ billion of that is delinquent. Another $4 billion in guarantees and 6 percent of that is delinquent?

Mr. HARMAN. Six percent, based on that.

Senator CONRAD. Let me ask you this. Is there a time lag that we had referred to at the last hearing, the time lag between the restructurings and the data processing to remove those restructured loans from the delinquency data? You are moving aggressively to clean up these accounts based on the Agricultural Credit Act.

Do you have any projection, within the agency now, as to what your portfolio will look like at the end of this year, and what you anticipate delinquencies to be at the end of the year?

Mr. JOHNSON. We establish goals for our people. Obviously, they are goals to seek.

Senator CONRAD. Could you share those with us?

Mr. JOHNSON. Those goals, though, we have not looked at them from the standpoint of being a precise estimate of exactly where we are going to be. I think you understand the use for which we provide those goals to our people, for their various programs.

Senator CONRAD. But you would try to make those goals realistic, because you are setting them as a management tool. Can you give me some rough idea of what those goals are?

Mr. JOHNSON. We are adjusting those. We have goals on delinquencies, numbers of inventory property, of course the use of funds, and all of those kinds of things. So we monitor a number of those.

We are trying to do a better job now of defining, because we think our goals will be more meaningful if we define some of these things. For example, we talked about what is delinquency earlier. We have three primary definitions of delinquency. So it depends on which report you want to do for which thing.

Senator CONRAD. Let me ask you this. What is your goal for the delinquent portfolio outstanding at the end of this year? You have $23 billion in direct loans. What is the goal for the end of the year?

Mr. HERTZLER. Technically, there should not be any delinquency, given the 1987 Agricultural Credit Act.

Senator CONRAD. There should not be any delinquency?

Mr. HERTZLER. Right.

Senator CONRAD. Realistically, what do you anticipate?

Mr. HERTZLER. At the end of this year, we have not seen the report yet, that would tell us how many new delinquencies we got, based on the January 1 payments. We will know that in a few days. Until we have seen that, we will not have any way of knowing exactly what it is going to project out to be.

Senator CONRAD. But do you have a projection now? Have you got the management goals set?

Mr. HERTZLER. Our projection on goals is to reduce or to process 80 percent of those that we started the processing under the Agricultural Credit Act of 1987. To have 80 percent of those processed to conclusion by June 30 of this year.

Senator CONRAD. By June 30, 80 percent. Do you have a goal then that would give you what the delinquency would be at that point?

Mr. HERTZLER. It depends in what happens in the processing of those, what happens to the delinquencies. If we get them processed through the accounting system and get them posted to the accounting system in a timely way, then that is what determines whether they are counted as delinquent or not.

So when we start processing of a borrower under 51-S, that stays in a delinquent status until we reach a certain place in the processing phase, and then that is removed from the delinquent status.

Senator Conrad. What do you anticipate? Do you think you will be at a 10 percent delinquency or a 5 percent, as we complete that process?

Mr. Hertzler. I guess I would say 10 percent, probably.

Senator Conrad. So we would be down from a 50 percent delinquency down——

Mr. Hertzler. From 30-some down to 10.

Senator Conrad. From 30 to 10.

Mr. Johnson. Based on which report now?

Mr. Hertzler. Based on 616 report.

Senator Conrad. I thought the delinquency was 50 percent.

Mr. Hertzler. Fifty percent is dollars.

Senator Conrad. Fifty percent delinquency is dollars, 30 percent is accounts. What will that look like, do you think? That would be more than 10 percent, then.

Mr. Hertzler. It all depends on how much we write off. That is how you get it off that delinquent status, of dollars.

Senator Conrad. So in either case, we are talking about a dramatic reduction in delinquencies?

Mr. Hertzler. We should be.

Senator Conrad. How about the total portfolio on direct loans? What do you anticipate that portfolio looking like at the end of this period? Down from $23 billion to half that much?

Mr. Hertzler. You are talking the total outstanding?

Senator Conrad. Yes.

Mr. Hertzler. If we write off as much as we are projecting, in finally working through the 77,000 that we have sent notices to, our projections run from $8 to $10 billion to be written off.

Senator Conrad. So we would be down to $13 to $15 billion.

Mr. Hertzler. From the 24. Plus, then you add back in what you make this year.

Senator Conrad. How much money would you anticipate to lend this year?

Mr. Hertzler. We will probably make about the same as we did last year, close to that.

Senator Conrad. $1 billion?

Mr. Hertzler. We made about $1 billion guaranteed last year and about $800 or $900 million of direct.

Senator Conrad. Let me raise one other question. I know it is getting very late and we have dinner being brought in. Texas barbecue. One more question and then we will fold this up. I very much appreciate your patience, but I think these are important issues we are talking about.

One of the things that I heard out there, and I heard again today from Mr. Buegler, was the need for more Farm Ownership money. When you factor in this transition to a new generation that has got to occur in agriculture, what is your response to the proposition that we need a lot more Farm Ownership money available?

Mr. Johnson. Obviously, if our goal is going to be to not only clean up our portfolio with the Agricultural Credit Act of 1987, but to clean up the portfolio of all other lenders, then that is possibly so. But we would like to get in a position where we were financing something other than refinancing debt.

He is asking us to have more FO direct loans, what he is wanting us to be able to do is take over more of their debt. No doubt, some of those people, they may not be able to stay with. Apparently North Dakota is the one State in the district that is having the greatest difficulty, so there would be more fallout there than anyplace else, from all that I have heard here.

But our farm bill proposal would not provide for that, and of course, that is what our budgets are in line with, is our farm bill proposal, that we not continue to refinance existing debt and that that farm operating loan with a guarantee be for beginning farmers and the socially disadvantaged. That would not provide a means to take these other borrowers.

Senator CONRAD. The question is where does the money come from? If FmHA is not going to be out there on providing Farm Ownership loans, but instead has dramatic reductions like you are going out of the business, where are the loans going to come from?

Mr. JOHNSON. A lot of those people are dropping out anyway, without asking someone.

Senator CONRAD. Sox, a lot of them are not. You know, you have all these farms out there in the hands of 55- and 60-year-old farmers. Somebody is going to need to take those operations over. Or is the plan that they not be taken over?

Mr. JOHNSON. Again, our hope is to define that level of when we are graduating and do a better job of that. That is something, if we do not do anymore out of all these hearings and our farm bill exercise, if we can define the niche of people that we are suppose to serve and how far down, how much risk should government be prepared to take with them. If we can define those two levels, we will have accomplished an awful lot. If it is clear enough for everyone to clearly see.

Once we do that, we are going to find there are some farmers out there that is not going to meet those standards, if we use any type of prudent lending. So to reach those, it is going to take something else. It is going to have to come from grant-type programs or something else, if it is going to be government or whoever's role it is to save those people.

Senator CONRAD. Correct me if I am wrong. It seems to me you are doing over $800 million in Farm Ownership and your proposal is—no?

Mr. HERTZLER. No. $800 million OL.

Mr. JOHNSON. Operating loans.

Senator CONRAD. What is your ownership money?

Mr. HERTZLER. About $80 million.

Senator CONRAD. What are you proposing to go to on ownership money?

Mr. JOHNSON. $38 million plus $50 million guaranteed subsidized to take up. So if you add those two together, you have $88 million with a combination of guaranteed subsidized and direct.

Senator CONRAD. What was your total last year?

Mr. JOHNSON. Our total last year, 1989 actual, was $95 million.

Senator CONRAD. Between the two you would have $88 million?

Mr. JOHNSON. Yes.

Senator **CONRAD**. In North Dakota I think you made $2.4 million in Farm Ownership loans last year. The need is dramatically higher than that.

Mr. **HERTZLER**. The need is for refinancing.

Mr. **JOHNSON**. That is it, refinancing. Should that be our goal, to handle the refinancing debt? We are suggesting, in our farm bill proposal, that that not be our goal in the future. We know we have to work through things.

Mr. **HUNT**. I think, Mr. Chairman, that the last hearing, February 8, when we released our report on loan use in fiscal year 1988, we did report that a substantial portion of the moneys used that year were for refinancing purposes, $665 million. When you look at who is doing that and for what kinds of purposes, I got interested this afternoon when the Farm Credit System representative talked about his district.

We ended up having $134 million of guaranteed ownership loans for the Farm Credit System that was for refinancing existing debt that they had, and $101 million for guaranteed operating loans for the System itself. Their numbers are close to that on the commercial banking side. So a lot of that is churning over existing debt that is being rolled over.

Senator **CONRAD**. Why is that happening? It is happening because the term has run out on the previous loan?

Mr. **DIGHTON**. Yes, I think it could be. I think FmHA is aware that back in 1987 they started a line of credit which is basically a 3 year line of credit and some of those for 2 years, so the loans are now coming due for refinancing. I think that is probably where the representative was speaking earlier, from the Farm Credit System, is *x* number of loans that he would have coming due that he needed refinancing on.

Mr. **HERTZLER**. The St. Paul District, they had a 3-year window in their restructuring program and that is now coming to a close. That has nothing to do with any timeframe on the guarantees. So shifting risk is the name of the game.

Mr. **DIGHTON**. But from the standpoint of the loans being made for a 2- or a 3-year time period, those are also coming due.

Mr. **HERTZLER**. Yes, we have some lines of credit coming due.

Ms. **ROTH**. But those you have rescheduling provisions for.

Senator **CONRAD**. I think we have these numbers wrong. Correct me if I am misunderstanding, but last year, in Farm Ownership guarantees, you had $299 million. Am I wrong? The appropriation was $474 million for Farm Ownership guarantees. And direct was $95 million. So between the two, as I read it, you had $570 million. Now you are talking about, between the two, going to $88 million.

Mr. **JOHNSON**. My table, Farm Ownership guaranteed unsubsidized in 1989 actual was $305 million. That is actual.

Mr. **HUNT**. With an authorized level of $724 million.

Mr. **HERTZLER**. Which included a transfer of $250 million over to guaranteed Farm Ownership for Farm Credit System sales of inventory property.

Senator **CONRAD**. Let us get for the record here, what is the fair comparison? What we had last year for Farm Ownership loans and what you are proposing for this year. What is the fair comparison? It sure is not $95 million to $88 million.

Mr. HERTZLER. It is down $15 million, correct me if I am wrong on that, Jim. The direct FO is down $15 million last year, from $95 million down to $80 million. And guaranteed is reduced to $469 million this year.

Senator CONRAD. What was last year? $474 million?

Mr. HERTZLER. It was approximately $427.

Mr. HUNT. But we are showing a current estimate in the budget document of $719 million for the guaranteed unsubsidized, 1990 estimate.

Senator CONRAD. $719 million.

Mr. HERTZLER. We have $474 million this year, guaranteed FO. It is about the same. It is close to the same, guaranteed FO this year and guaranteed FO last year.

Mr. HUNT. Right, we are showing $724 million last year and a 1990 estimate of $719 million.

Senator CONRAD. Then what is the President's budget?

Mr. JOHNSON. For 1991? $100 million. But then there would be no refinancing involved in that.

Senator CONRAD. I know, but the point is this. There is a big demand out there and the President's budget is just going to ignore it. There is a need out there. Everywhere I go, I hear it. We are talking about going from $700 million to $100 million.

I just do not know how this all adds up and comes together. What is the real world result? I think I know what the real world result is. There is going to be a whole lot of folks going out of business, a lot fewer farms out there, and that means small businesses in these small towns failing. These people go to the big city and look for work.

Is that really what we want to do?

Mr. JOHNSON. Well, actually on the speed at which we make these changes and the magnitude to which we support them, obviously we are going to have to get into the budget and I am sure you are going to be making recommendations to the budget. How fast can we go?

This budget, the administration's proposal, was developed to be consistent with the administration's proposal for the farm bill, obviously, so you do need to keep that in mind as you are looking at these numbers.

Senator CONRAD. That is what I am trying to do here. I am trying to match up things so that we get some sense of what we are really talking about. What is going to happen out there in the real world? Because very often I find that there is a disconnectedness between what we talk about, the rhetoric and what happens in the real world.

What we are talking about is a dramatic cutting of Farm Ownership loans from 1990 to 1991 at the very time that demand is going up because the aging of this farm population and the need to move Farm Ownership to a new generation.

It just does not seem, to me, to meet the reality that we confront out there.

Mr. JOHNSON. Again, I guess it is how big a role should the Federal Government undertake in covering the risk for the private sector that is currently providing that financing, because we are saying that most of this is refinancing. So if we are not going to do the refinancing, that means somebody is refinancing them now.

Senator CONRAD. What you are talking about, Sox, is going from $700 million in loans you are making now, to $100 million. So you are saying that the Federal Government's role is being decimated.

Mr. JOHNSON. That is correct. That is what the proposal in the farm bill would be.

Senator CONRAD. Let me, again, thank the witnesses. I appreciate very much your patience and your participation. I feel this has been a useful exercise and I, again, very much appreciate your assistance.

With that, we will close the hearing. We will leave the record open for 2 weeks.

[Whereupon, at 6 p.m., the subcommittee recessed, to reconvene at 9:35 a.m., Monday, March 5, 1990, in room SR-332, Russell Senate Office Building.]

PREPARATION FOR THE 1990 FARM BILL

Implementation of the Agricultural Credit Act of 1987 by the Farmers Home Administration

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MONDAY, MARCH 5, 1990

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL CREDIT OF THE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:35 a.m., in room SR-332, Russell Senate Office Building, Hon. Kent Conrad (chairman of the subcommittee) presiding.

Present or submitting a statement: Senators Conrad and Gorton.

STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. This hearing before the Subcommittee on Agricultural Credit, on "The Implementation of the Agricultural Credit Act of 1987," will come to order.

Good morning. I especially want to welcome the witnesses and the audience to this hearing of the Subcommittee on Agricultural Credit. Today we are here to discuss the implementation of the Agricultural Credit Act of 1987 by the Farmers Home Administration. In addition, we will discuss the need for changes to the act to correct problems that were unforeseen at the time the act was passed.

The Agricultural Credit Act of 1987 was passed by Congress to deal with the severe delinquency problems in the Farmers Home Administration. Let me take a few moments to review the problems faced by agriculture and agricultural lenders in the 1980's.

First, in the 1980's, net farm income, adjusted for inflation, fell to record lows. In fact, average net farm income in the 1980's was lower than in any decade since recordkeeping began in 1910. It has recently been reported that farm income has reached record highs in the last few years—that is not true once inflation is taken into account. (See the chart "Net Farm Income History" on p. 378.)

Second, this sharp drop in farm income drove the value of farm assets down dramatically. Between 1981 and 1987, total farm assets, adjusted for inflation, dropped from a value of $1.1 trillion to a little over $600 billion—a drop of nearly 50 percent in 6 years. (See the chart "Total Farm Assets" on p. 379.)

Clearly, many farmers, facing reduced incomes and the loss of their asset bases, were simply unable to meet their financial commitments. Many of these farmers were in trouble because they listened to the advice of the so-called experts—university economists, bankers, and financial advisers—that the best way to get ahead was to leverage to the hilt to produce for the rapidly growing demand for exports. But when farmers' incomes in the 1980's dropped by about 40 percent in real dollars and the value of their assets dropped by even more, many farmers were simply not able to make ends meet. The most tragic farm bankruptcy cases are those of farm parents who borrowed to get their sons and daughters started in farming in the late 1970's or early 1980's. In many cases, the parents lost their entire life's work in just a few years. How many of us could have survived?

Hundreds of agricultural banks failed; the Farm Credit System contracted by 40 percent and needed a $4 billion assistance package, less than $2 billion of which has been used, and the Farmers Home Administration suffered significant losses.

Compounding the problem for FmHA is the fact that their mission is to lend to young and beginning farmers and farmers with good management skills, who are temporarily in need of lower interest credit. By the summer of 1987 when we were debating the Agricultural Credit Act, FmHA had over $7 billion in delinquencies. No payments had been received on over $5 billion of that debt for 3 years or more. (See the chart "FmHA Loan Delinquencies" on p. 380.)

To resolve this severe problem and to get FmHA through the farm depression of the 1980's, the Congress passed the Agricultural Credit Act of 1987. I have overseen the implementation of the act as chairman of this subcommittee for just over a year. The act, in my judgment, is a good piece of legislation. I want to emphasize that the act was not written just to resolve the problems of the farm depression of the 1980's. It was designed to put in place a reasonable, fiscally responsible policy for FmHA to follow whenever delinquencies occur, particularly during future farm depressions.

I am committed to correcting any errors we may have made in drafting the 1987 legislation and in correcting FmHA's deficiencies in the administration of the program. As part of that effort, I requested the Office of Inspector General of the Department of Agriculture to investigate specific problems and answer specific questions so that the committee could proceed with full knowledge of the exact nature of the problems.

Mr. James R. Ebbitt, Assistant Inspector General for Audit, is here today to report on their progress. In partial response to my inquiry, OIG will be reporting on a review of 74 borrowers with large write-offs. Their findings indicate that 96 percent of the losses incurred by FmHA from these 74 borrowers were due to Economic Emergency and Emergency Disaster loans. I want to make clear that Congress has already eliminated the Economic Emergency Loan program and sharply curtailed use of the Emergency Disaster Loan Program. These actions by Congress, by the way, were taken before I was ever a Member of Congress, but I do think it is instructive that Congress has acted already to eliminate or sharply curtail those programs that have caused by far the biggest part of the problem. In response to my questions, OIG found that, under current law, most of these loans—84 percent by value—would not have been made. The two basic loan programs most used by FmHA borrowers—the Farm Operating and Farm Ownership Loan Programs—accounted for only 4 percent of the losses in this sample of borrowers.

Testimony from the General Accounting Office confirms OIG's findings. In a previous hearing, GAO has agreed that the majority of losses are due to the severe economic conditions of the 1980's and that the loan programs suffering the largest losses were the Economic Emergency and Emergency Disaster Loan Programs. Again, these programs have been eliminated or sharply curtailed by Congress in the mid-1980'.

There are clearly some additional problems Congress must correct. However, unless we are willing to cripple the basic mission of the act, further changes should be carefully focused on minor legislative changes and administrative problems.

With that, let me conclude by saying all of us have an interest in making sure that we clear up those problems that exist. As some of you may know, late last year I passed through the Senate a measure to take care of those who have acted in bad faith so that they would not have the benefit of net recovery buyouts. Many of us thought they were already prohibited from buyout eligibility by the law. In addition, we have learned that that section of the act that was intended to prohibit write-down eligibility to those whose delinquencies were within their control, is somehow not working as was intended. We need to review that.

But there are other issues as well that we will want to review today. Let's turn to those who will be testifying.

[The prepared statement and charts of Senator Conrad follow:]

STATEMENT OF SENATOR KENT CONRAD

SUBCOMMITTEE ON AGRICULTURAL CREDIT
HEARING ON THE IMPLEMENTATION OF THE AGRICULTURAL CREDIT ACT OF 1987 BY FARMERS HOME ADMINISTRATION

MARCH 5, 1990

Good morning. I welcome the witnesses and the audience to this hearing of the Subcommittee on Agricultural Credit of the Committee on Agriculture, Nutrition, and Forestry. Today we are here to discuss the implementation of the Agricultural Credit Act of 1987 by the Farmers Home Administration. In addition, we will discuss the need for changes to the Act to correct problems that were unforeseen at the time the Act was passed.

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First, in the 1980s, net farm income, adjusted for inflation, fell to record lows. In fact, average net farm income in the 1980s was lower than in any decade since record keeping began in 1910. I know the media sometimes hears that farm income has reached record highs the last few years -- that is not true once inflation is taken into account. (See the chart based on data from the USDA.)

Second, this sharp fall in farm income drove the value of farm assets down dramatically. Between 1981 and 1987, total farm assets, adjusted for inflation, dropped from a value of nearly $1.1 trillion to a little over $600 billion -- a drop of nearly 50% in six years. (See chart on total farm assets.)

Clearly, many farmers facing reduced incomes and the loss of their asset bases were simply unable to meet their financial commitments. Many of these farmers were in trouble because they listened to the advice of the experts -- University economists, bankers, and financial advisors -- that the best way to get ahead was to leverage to the hilt to produce for the rapidly growing demand for exports. But when farmers' incomes in the 1980s dropped by about 40% in real dollars and the value of their assets dropped by more, many farmers were simply not able to make ends meet. The most tragic farm bankruptcy cases are those of farm parents who borrowed to get their sons and daughters started in farming in the late 1970s or early 1980s. In many cases, the parents lost their entire life's work in a few years. How many of us could have survived?

Hundreds of agricultural banks failed, the Farm Credit System contracted by 40% and needed a $4 billion assistance package, and the Farmers Home Administration suffered significant losses.

Compounding the problem for FmHA is the fact that their mission is to lend to young and beginning farmers and farmers with good management skills who are temporarily in need of credit. By the summer of 1987 when we were debating the Agricultural Credit Act, FmHA had $7 billion in delinquencies. No payments had been received on over $5 billion of that debt for three years or more. (See chart.)

To resolve this severe problem and to get FmHA through the farm depression of the 1980s, the Congress passed the Agricultural Credit Act of 1987. I have overseen the implementation of the Act as Chairman of this Subcommittee for just over a year. I am convinced that the Act is a good piece of legislation. I want to emphasize that the Act was not written just to resolve the problems of the farm depression of the 1980s. It was designed to put in place a reasonable, fiscally responsible policy for FmHA to follow whenever delinquencies occur, particularly during future farm depressions.

I am committed to correcting any errors we may have made in drafting the 1987 legislation and in correcting FmHA's administration of the program. As part of that effort, I requested the Office of Inspector General of the Department of Agriculture to investigate specific problems and answer specific questions so that the Committee could proceed with full knowledge of the exact nature of the problems.

Mr. James R. Ebbitt, Assistant Inspector General for Audit, is here today to report on their progress. In partial response to my inquiry, OIG will be reporting on a review of 74 borrowers with large write-offs. Their findings indicate that 96% of the losses incurred by FmHA from these 74 borrowers were due to economic emergency and emergency disaster loans. The importance of this finding is that the Congress has already eliminated the economic emergency loan program and sharply curtailed use of the emergency disaster loan program. In response to my questions, OIG found that, under current law, most of these loans -- 84% by value -- would not have been made. The two basic loan programs most used FmHA borrowers -- the farm operating and farm ownership loan programs -- accounted for only 4% of the losses in this sample of borrowers.

Testimony from the General Accounting office confirms OIG's findings. In a previous hearing, GAO has agreed that the majority of losses are due to the severe economic conditions of the 1980s and that the loan programs suffering the largest losses are the economic emergency and emergency disaster loan programs.

There are clearly some additional problems that Congress must correct. However, unless we are willing to cripple the basic mission of the Act, further changes should be focused on minor legislative changes and administrative problems.

Based on these and other findings, I am very concerned about proposals forwarded by the Administration and others that seek to radically change the 1987 Act. Many members, and the public, seem shocked by the "losses" that are showing up on the budget as FmHA resolves the loan delinquencies that were allowed to accrue prior to passage of the Act. These are losses that had already occurred at the time the Act was passed. It almost seems as though some have forgotten the reasons we passed the Act.

During the farm depression, FmHA began incurring large losses. Its response to this crisis was to withhold the release of borrowers' essential living and operating expenses, and to foreclose on its borrowers. A court ruling on a class action suit brought against FmHA found that the agency was not providing adequate notice of borrowers rights. It placed a moratorium on FmHA foreclosures until FmHA published regulations outlining borrowers rights, and implemented the loan servicing program in law at that time.

FmHA refused to do so. In fact, its Administrator at the time stated at a hearing of the Senate Agriculture Committee that he believed that it was immoral for the federal government to write-down debt, even when the federal government could return more to the Treasury through loan restructuring then through foreclosure. The former Administrator even admitted that as a private lender he wrote down debt when it made good business sense; i.e., when he could collect more through restructuring than foreclosure. Given this attitude, the only option to foreclosure for FmHA borrowers was the bankruptcy court. Yet our courts simply could not handle 70,000 bankruptcy cases. By 1987, $7 billion of FmHA's outstanding debt was delinquent. As a result of its inaction, 78% of that debt was over 3 years delinquent. Much of that amount was interest which was allowed to accrue because FmHA failed to act.

Faced with these problems, Congress had to act. We enacted legislation based on a program first developed by the St. Paul Farm Credit District, part of the farmer-owned Farm Credit System cooperative. That legislation -- the Agricultural Credit Act of 1987 -- requires FmHA to foreclose on a loan or restructure a loan, depending on which option would return the most to the federal government. (In addition, the legislation shored up the Farm Credit System by providing a $4 billion line of credit. So far, FCS has used approximated $2 billion, and seems to be on the road to recovery.)

Essentially, we forced FmHA to be fiscally responsible, writing down debt only when it is the least cost alternative. We developed explicit borrowers rights so that delinquent borrowers knew what was expected of them, and what they could expect from FmHA. We established an internal independent appeals process.

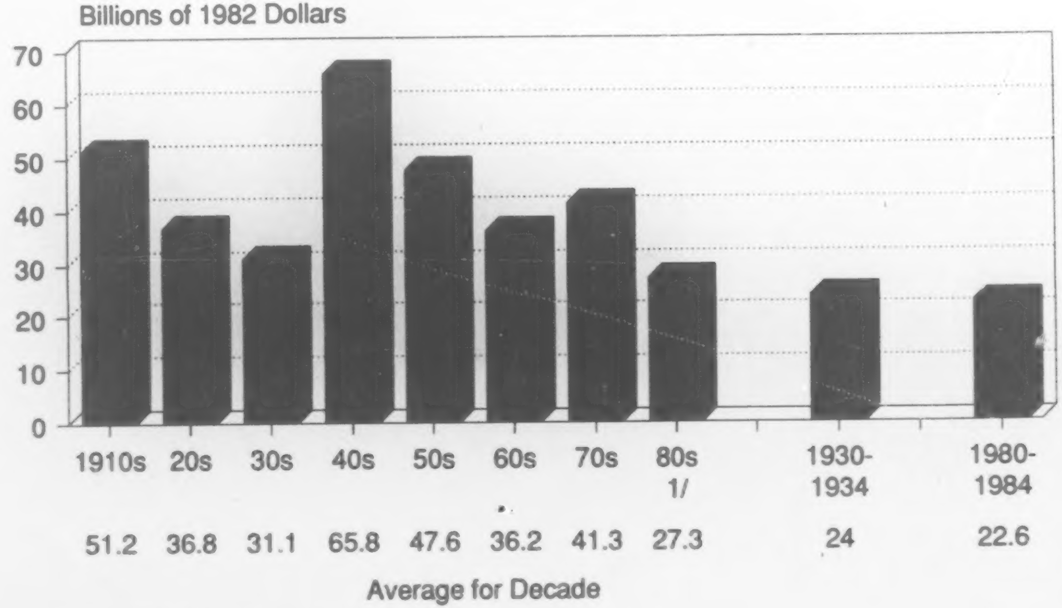
After much effort spent in passing and implementing these provisions, we now have in place at FmHA a loan servicing program which is fair and fiscally responsible.

The evidence is clear that the federal government has and will continue to receive more money though careful implementation of the Act than through a policy of massive farmer liquidations. The key is whether the law is being properly implemented.

Some, however, are not satisfied. Some want to eliminate FmHA's ability to restructure debt even when it is the least cost alternative. Some have used the few cases of alleged abuse of the program to discredit the program, even when those abuses are often the result of FmHA's own improper implementation of the Act. OIG will be reporting on a specific case in which FmHA's misadministration resulted in a loss of nearly $1 million to the agency. We will be looking into the causes of that problem, and what administrative steps are needed to prevent it from happening again.

We have much to discuss today. Let us begin.

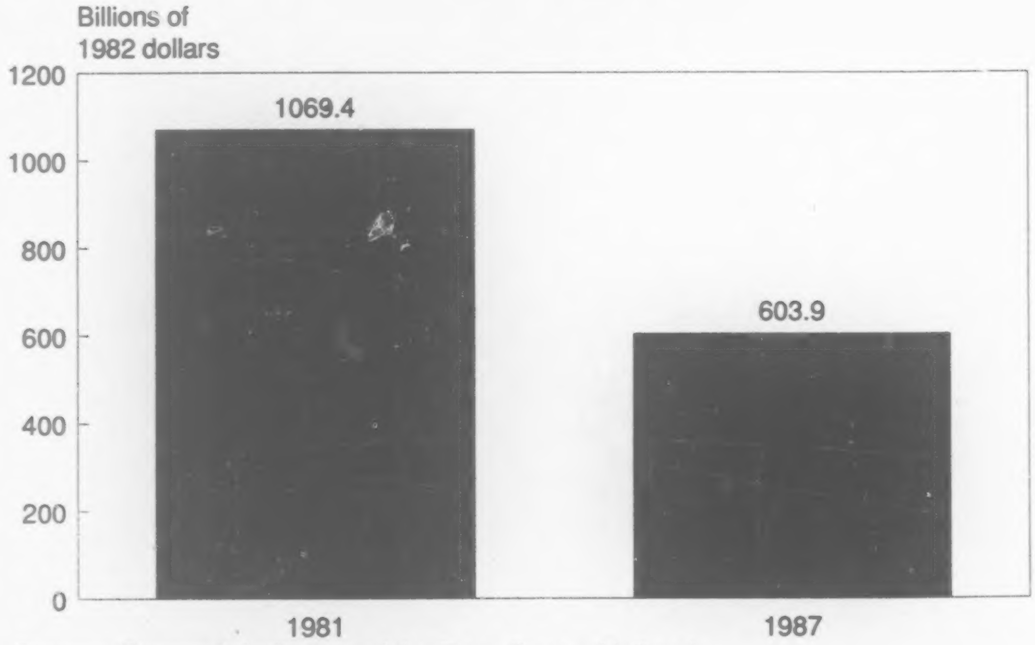
Net Farm Income History
Constant (1982) Dollars



Source: USDA ERS Farm Income Data:
A Historical Perspective , SBN 740.
1/ 1980-88

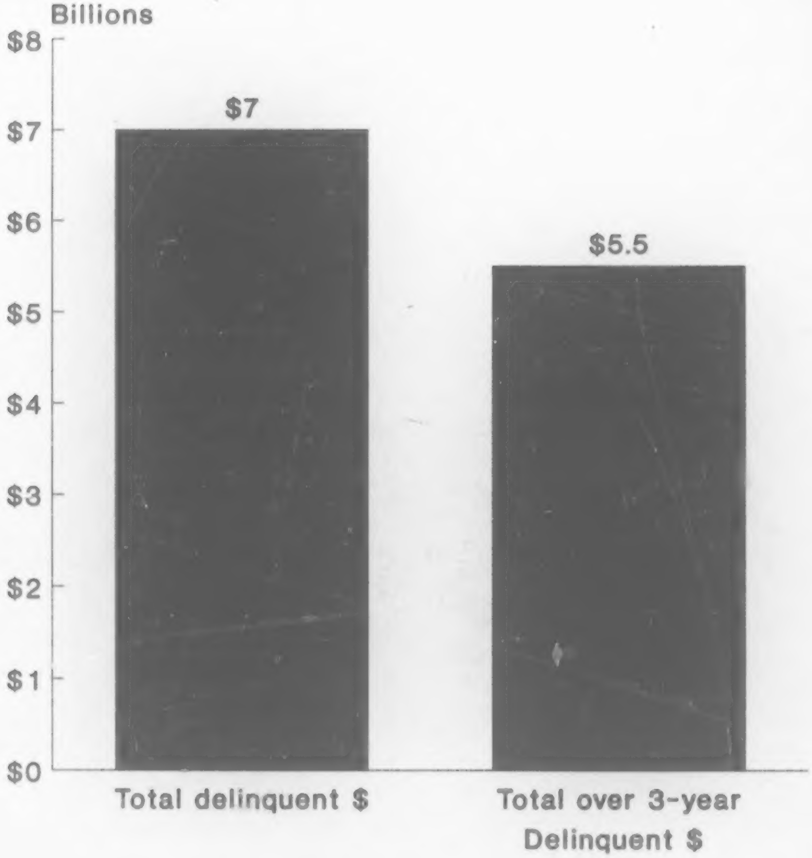
TOTAL FARM ASSETS

1981 & 1987



Source: Economic Indicators of the Farm Sector, National Financial Summary, 1985, 1987; USDA

FmHA Loan Delinquencies 1987



Source: GAO Briefing Paper for Sen. Conrad (June 30, 1987)

Senator CONRAD. If I could call to the stand now Roland Vautour, Under Secretary for Small Community and Rural Development, U.S. Department of Agriculture; James Ebbitt, Assistant Inspector General for Audit, Office of Inspector General; John Harman, Director of Resources, Community and Economic Development Division of the General Accounting Office; and Lynn Hayes, Minnesota Project Director of the Farmers' Legal Action Group.

Welcome, all of you. It is good to have you here.

As so many of you all know, I think this may be the fourth hearing on this subject that we have held this year. They have been really excellent hearings, I have felt. I certainly feel that we have explored the issues in some detail. Now we are going to get down to the brass tacks of what do we do to clear up the problems that are out there. That is really what this hearing is all about.

In previous hearings we have talked about the dimensions of the problems, we have surfaced some disagreements as to how to deal with the problems, but now we need to focus on specific solutions.

With that, I want to welcome Under Secretary Vautour. Please proceed. The rules of the game are, as always, if you can summarize your testimony, that is fine; the full testimony will appear in the record.

Once we have gone through the panel, we will have a chance for questions and interchange.

STATEMENT OF ROLAND R. VAUTOUR, UNDER SECRETARY, SMALL COMMUNITY AND RURAL DEVELOPMENT, U.S. DEPARTMENT OF AGRICULTURE, WASHINGTON, DC; ACCOMPANIED BY NEAL SOX JOHNSON, ACTING ADMINISTRATOR, FARMERS HOME ADMINISTRATION

Mr. VAUTOUR. Thank you, Mr. Chairman.

INTRODUCTION

May I commend you for holding this hearing because I think we all agree that the Agricultural Credit Act of 1987 is a worthwhile piece of legislation, and in my judgment ought to be protected, and the integrity of that act ought to be jealously guarded. If you will take my remarks in that framework and with that rationale behind any comments that I may make—they are not to be construed as a criticism nor as an effort to dilute, if you will, the effectiveness of the act, because I think it has accomplished a great deal. Like everything else, nothing is perfect, and many of the anomalies that have developed, developed unforeseen, with no foresight on the part of anybody; it was just that we had no way of knowing.

With that, Mr. Chairman, I would like to——

Senator CONRAD. Let me just thank you for that preamble, because I do think it is terribly important to put this thing in context.

Mr. VAUTOUR. Absolutely.

Senator CONRAD. Let me just say I am in full agreement with that preamble. I believe the Agricultural Credit Act of 1987 was a good piece of work, dealing with an extraordinary problem that we faced. But any time we have as comprehensive a piece of legislation as that one, you have problems. Let's identify them and fix them, in the spirit of cooperation. I appreciate very much the spirit in which you have come.

Mr. **VAUTOUR**. I am totally sincere in that, Mr. Chairman.

I am going to try to summarize as best I can, but there are seven or eight specific points that I would like to address in some detail.

Senator **CONRAD**. Please feel free to take whatever time you believe is necessary to make the points that you want to make.

Mr. **VAUTOUR**. Thank you.

NOTICES

We have mailed notices to some 75,000 borrowers who were more than 180 days delinquent. We were able to resolve about 32,500, leaving 42,000 who really were unresolved, and they were unresolved because they simply did not respond. We have to assume that they either were not interested or that, more likely, they have since left farming.

UNRESOLVED CASES

Let me discuss the latter category first, the ones that we did not resolve. The figure includes 4,774 cases of mediation pending or yet to be resolved; 3,300 accelerated accounts pending disposition; 2,452 leaseback/buyback and homestead protection options; and 32,000 in the "other" category. That comprises the 42,000 that are yet unresolved.

WE THINK THE PROCESS IS WORKING

And this, I will submit for the record because I don't want to bore everyone here with the recitation of a substantial number of statistics. But suffice it to say that we think the process is working, perhaps in some instances not as well as we would like to see it work, but we think that we can work our way through these problems using, in many instances, the authorities that are available to us in terms of existing servicing activities; and obviously, when all else fails, and no other way can we do it, the utilization of the write-down and/or the net recovery buyout.

But we have had an opportunity for some two rounds, if you will, 65,000 or so that we mailed out the first time and some 10,000 notices that we mailed this year.

CERTAIN ANOMALIES OF THE ACT THAT WERE UNINTENDED IN MY JUDGMENT

There are certain anomalies of the act that were unintended in my judgment—and I'm sure I'd get little argument on that—that have emerged that we think need correction and need to be looked at to preserve the integrity of the act and to preserve that which we thought was the best and smartest way to approach it, which was that if it was cheaper for the Government to write-down a debt rather than liquidate, then chances are pretty good that we would have a better chance to get some of that money back.

CAN YOU GIVE US SOME FEELING ON THE 42,000 THAT ARE UNRESOLVED?

Senator CONRAD. Let me just stop you for a moment before you go forward with those points. I want that to be a clear separation between those points and the first part of your testimony where you describe those cases that are unresolved. Can you give us some feeling on the 42,000 that are unresolved? Has there been any sampling for us to be able to know how many of those folks are out of the farming business?

Do we have any hard data that tells us how many of those folks are out of farming?

Mr. VAUTOUR. We really do not know specifically because it was just a matter of nonreply. We will know that as we work our way through that 42,000, but at the present time I don't think I have a way of giving you a hard figure.

Senator CONRAD. Would some number of those be people that responded beyond the deadline or responded in a partial way and therefore——

Mr. VAUTOUR. There were probably some of those, Mr. Chairman——

Senator CONRAD. Do you have any feeling for the numbers there?

Mr. VAUTOUR. No, I do not. But we will try to get that and furnish it to you for the record.

Senator CONRAD. All right.

Mr. VAUTOUR. But I think it is safe to say that with what we used as what we would call the rule of reason, if there were a legitimate attempt made to meet that 45-day deadline, we extended it, in most cases, and it had to be a pretty blatant violation on their part, just totally ignoring the thing, before we actually decided that there was noncompliance at all.

Senator CONRAD. So your best sense is that the significant majority of those 42,000 are out of farming? Is that your best sense?

Mr. VAUTOUR. Of that 42,000, 32,000 still are unresolved, and yes, we think that most of those have probably since left farming, but we do not know that to be sure.

Senator CONRAD. Of the 32,000 that are unresolved?

Mr. VAUTOUR. That's right.

PROBLEMS WE HAVE FOUND IN THE ACT

But Mr. Chairman, I would like to list several problems that we have found in the act and discuss them, and then give you our recommendations to again establish what I consider to be a solid base upon which to continue the implementation of the Agricultural Credit Act.

The first problem that we discovered was the net recovery buyout. It is far too easy for a borrower to make a financial windfall under the present statute. I will address each of these in further detail.

Second, good faith, which obviously, Mr. Chairman, you are familiar with in the legislation that was passed this past year. An opportunity exists for bad faith dealings.

Third, limits on restructuring. A borrower could return for unlimited write-downs under existing language.

Fourth, no limit on loans eligible. Under present law, loans being made today, and in the future, would be eligible for restructuring, including write-down.

Fifth, limits on debt forgiveness. Huge amounts are presently being forgiven because there is no dollar limit in the law.

Sixth, the use of other assets. Many borrowers have assets that could be used to reduce their debt, if they were required to use them.

Seventh, inventory property. Current law gives windfalls to some farmland purchasers.

Eighth, inadequate deadlines. I refer here to that infamous 45 days, and I'm sure we'll all soon forget, but where we think that those time lines ought to be extended both for the borrower replying and for Farmers Home to respond to them.

Now let me go over those points in more detail.

NET RECOVERY BUYOUT

In net recovery buyout, the borrower is given an opportunity to buy out the loan at the current market value of its existing security minus prior liens and costs associated with acquiring, maintaining and disposing of inventory property.

This option is available to borrowers who do not qualify for loan restructuring with debt write-down. The recapture period is only 2 years compared to 10 years for a write-down, and there is no recapture of appreciation for buyouts. There is no prohibition against selling the property for the same price, or less, than the buyout price—and on the same day, at that, and we would not recapture if there were a subsequent sale.

We recommend:

One, that we require sales to be conducted at arm's length or have recapture computed on appraised market value at the time of sale even if the sale is for less than the market value.

Two, extend the recapture period for buyouts to 10 years, the same period as write-downs.

Senator Conrad. Let me just interject as you go along.

I think the extension makes good sense. Now, there are those who are going to argue on that point, but there should be some equivalent treatment between the two. I think that is something that we can rapidly form consensus on.

Thank you.

GOOD FAITH DEALINGS

Mr. Vautour. Good faith dealings. Borrowers who have not acted in good faith—such as those who convert security—are still eligible for the buyout option even though the statute makes them ineligible for write-downs. In write-downs, the amount of the debt can be reduced to the net recovery value of collateral if that restores the cash-flow ability of the borrower.

This could encourage conversion, which, in our case, usually means the sale without our knowledge or consent of crops, livestock, or equipment on which we have a lien. We have been required to offer buyouts to borrowers who have failed to deal with us in good faith.

An example, from Wyoming, involves a borrower who disposed of property on which FmHA had a lien and did not apply any of the proceeds to the debt. This resulted in an immediate monetary loss of $251,814. Even though FmHA was able to document the facts in the case, the borrower still has the net recovery buyout option. If that option is exercised, FmHA will be required to accept $45,361 as the net recovery buyout based on the remaining asset value, in full settlement of the debt, and take an additional loss of $340,924, for a total loss of $592,738.

Another case, from Minnesota, involved three members of a family who have disposed of FmHA-mortgaged property for which they received more than $500,000 and FmHA received nothing. They still qualify for net recovery buyout, which would result in debt forgiveness of $1.75 million, if approved, meaning an overall loss to the taxpayers of over $2.2 million. These are only two of a number of cases.

We estimate the cost of bad faith transactions alone to be more than $88 million to the Government, that is, to the taxpayers.

WE RECOMMEND

We recommend imposing a good faith requirement, the same as now applicable to debt write-down, on net recovery buyout transactions and preservation loan servicing actions. Allow FmHA to value all assets originally pledged, even if they have been converted by the borrower.

Are there any questions, before I go on?

Senator CONRAD. Let me just say to you that we have a meeting of the minds on your second point, because as you know, we passed legislation to resolve this problem in the Senate. I understand the House now has moved through committee something that would address this same problem. I think most Members believe that when we passed the Agricultural Credit Act of 1987, the good faith provision applied to both restructuring and buyout eligibility. So I think that is something clearly we'll want to check out.

Mr. VAUTOUR. Thank you, Mr. Chairman.

LIMITS ON RESTRUCTURING

A borrower should be limited to one restructuring with write-down. The Agricultural Credit Act imposes no limitation in this regard, and this raises the very real possibility that a borrower could receive a write-down, again become delinquent, and go through the entire process again.

Multiple write-downs could easily occur if the net recovery value of the security continued to decline, as in the case of chattels, so that, with each restructuring calculation, its net recovery value would be less than the value of the payments on the newly restructured loan. It is not appropriate to regularly reduce loans when the value of security such as tractors and the like diminishes. Repayments should match depreciation schedules.

In addition to reducing any incentive for a borrower to remain current on loans, this perpetual availability of write-down would continue to cost the taxpayers. An important, though unfortunate, result would be the clear and strong message to other borrowers that this approach encourages continuing delinquency. One opportunity allows a good farmer to recover from his problems and to get a clean start.

WE RECOMMEND

We recommend limiting loan restructuring with debt write-down to one such action per borrower.

I might interject here, Mr. Chairman, that we have done some preliminary work with the National Finance Office, and while the figures that I am about to give you are at best very fuzzy, they give us an indication. We will have some hard figures, we think, within 2 to 3 weeks, but at the present time, better than 25 percent of those folks who were restructured in the first go-around are now delinquent again, which would permit them to again qualify for an additional write-down.

Senator CONRAD. Mr. Secretary, on that point. Others have said to us, including the State FmHA director in North Dakota, that the restructuring calculation was so tightly calibrated on the first round of restructurings, that we could fairly anticipate that some of these restructured borrowers would need servicing again, especially given the continuing drought. That is a very serious problem that we face in my part of the country, and other parts of the heartland as well.

First, let me get your response to that. Did we set ourselves up for this problem by the way the calculation was done in the first place, that is, that the cash-flow was so tightly calibrated that we could fairly anticipate, especially with the continuing drought, that people would need back additional servicing?

Mr. VAUTOUR. The chances are pretty good, Mr. Chairman, that that is correct. But the law stated that we would write down to the level of cash-flow, and certainly not beyond that, because then it became a judgmental thing open to considerable abuse, if you will, and I guess inequitable administration throughout the—when we have 1,900 county offices, there is no reason to expect that every one of those 1,900 County Supervisors are going to use the same judgment.

Senator CONRAD. Let me just follow up. Farm Credit Services of St. Paul, for example, testified that they have just done a remarkable thing—they interceded in what was a disaster; they have gotten a tremendous amount of these delinquencies cleared out of the System and are in the process of clearing more out; don't take out of our hands one of the important tools that we have—debt forgiveness—by limiting it to one time.

In the private sector, you wouldn't limit it to a one-shot, especially given the prospects for a third year of drought. They are saying to us don't take it out of our hands; find some other way to bell this cat.

Would you comment on that?

Mr. VAUTOUR. Well, I guess I have to look at it and we have to look at it from the point of view that the Agricultural Credit Act was enacted, obviously in response to what was then a very major—I shouldn't use the word "disaster", but I guess perhaps that's as good a description as any—and we just feel that the continuing write-down availability sends the wrong message; it is just bad credit management. If a person knows that all they have to do is to fall delinquent again, and if their assets have declined, would be eligible for write-down, we just think we ought to tighten that up.

Senator CONRAD. Let me just say to you that we don't want to leave a misimpression. The delinquency must be due, according to the act, to circumstances beyond the control of the borrower to be eligible for write-down. What concerns me here is what those from the private sector said to us as well as Farm Credit Services and other farm lenders—you in Congress and the administration gave us the tools to deal with a very serious set of problems; for goodness' sake, don't take that set of tools away from us now. Leave them with us.

It is always the case, certainly in private sector borrowing, that it is possible to get debt write-down if that is the best thing for the lender. Of course, the Agricultural Credit Act was designed to provide maximum recovery for the Federal Government. I am concerned that we don't throw out the baby with the bath water here, inadvertently. Perhaps the point is made, but we hear your point as well.

Mr. VAUTOUR. Thank you.

THERE IS NO LIMIT ON ELIGIBILITY

Under present law, borrowers with loans made at any time, including the last 2 years when net farm income was near record levels, could let their payments slide and, yet, be eligible for loan servicing under the act. This does not provide encouragement to borrowers to keep their loans current, which is what we have addressed in this past discussion.

We believe that Congress' intent was to help those borrowers who suffered financial distress through no fault of their own as a result of the general economic downturn during the mid-1980's.

WE RECOMMEND

We recommend that loans closed after a cut-off date of January 6, 1988, the date the act was signed into law, would not be eligible for the extraordinary restructuring rights with debt write-down or net recovery buyout in the 1987 act. They would, however, continue to be eligible for the very substantial FmHA loan servicing such as consolidation, rescheduling, reamortization, deferral, and the lowering of interest rates.

Senator CONRAD. Let me just ask you on that point why should we treat FmHA borrowers differently than private sector borrowers or other farm borrowers whose lenders have the ability to use those tools?

I guess this proposal is the one that concerns me the most. We put in place this structure to deal with the problem. If there is one thing we probably know from watching the cycles of agriculture, it is going to come again. I hope and pray that we don't leave FmHA back in the old fashioned buggy days that we went through in the 1980's when they did not have the management tools to deal with the crisis and so the debt piled up. We got interest on debt and interest on debt and it kept accruing.

I guess this proposal is the one that really does concern me the most, that we take out of FmHA's hands the most important tools that were given them.

Mr. **Vautour**. In the case of the private sector, Mr. Chairman, whether they write-down the debt or whether they do not is pretty much a voluntary thing and a discretionary thing that the local bank or local farm credit bank president has the right to decide—yes, we'll do it, or no, we won't.

Under the Agricultural Credit Act of 1987, we are locked into it. We don't have that discretion. And I guess my reaction is that, really, in terms of credit management, which is one of the major problems that we have at Farmers Home—and I don't mean to leave you with the impression that we think Farmers Home is lily white in that respect—we have all kinds of problems—but in order to come to grips with the whole concept of credit management, we just don't think it is good policy to be sending a message to the people who say, well, you can pay the Farm Credit System, you can pay the bank, and you pay Farmers Home nothing; go delinquent for 180 days, and you are eligible for a write-down—because most of this was due to circumstances beyond their control, but still, by discretion they decide to pay others rather than us. We just think that they ought to realize that that is a debt like any other debt and that we expect full repayment.

Senator **Conrad**. Again, it strikes me that we are getting here at a question of administration because the law provides that you only do that when the circumstances are beyond the control of the borrower. In the situation you describe, it is not beyond the control of the borrower. We should not allow them administratively to ever pull that kind of scam on us. It seems to me we have the protection to prevent that from occurring.

The other point I think is terribly important to make—this act is designed to get maximum recovery from the Federal Government. We go through a calculation to determine how we get maximum recovery, and if maximum recovery lies in restructuring, we ought to do that. That is good credit management.

I used to be the biggest creditor in the State of North Dakota. I was the tax commissioner. I'll tell you if there is one thing I learned, it is when somebody goes delinquent, you move—you move quickly. You recover as much as you can, as fast as you can, because the longer it goes, the worse it gets. And if there is anything we should have learned from the 1970's and the 1980's, it is that is exactly what happened to all ag lenders. Those that moved quickly and had the tools to move quickly had the least losses.

So again, I just think we have to think very, very carefully about this proposal. And I am wondering if there is not some other way that we could send a clear signal to folks that if you have a debt you can pay, we'll expect you to pay it. This is not some deal where a borrower can say, oh, gee, I just don't feel like paying, so I'm not going to pay. Oh, no. That's not the way the Agricultural Credit Act was designed, and we ought not to allow that to occur.

Mr. **Vautour**. Unfortunately, Senator—I agree with you totally—but unfortunately, the problem that we run into is to define that nebulous and nefarious thing that is called "beyond his control". It is just almost impossible for us to determine that. That has been the bugaboo that has been bothering us in this whole thing. And in many cases, we have been subordinating for a number of years that we have permitted people to take a prior lien rather than make the loan, and they feel perfectly justified in paying off the prior liens before they pay us off.

So it is one of those things that is very, very difficult to pin down.

Senator CONRAD. All right.

LIMITS ON DEBT RESTRUCTURING

Mr. VAUTOUR. The lack of any dollar limitation on the amount of debt that can be forgiven has produced some cases that clearly were hard to believe even though they were legal and required under the act. These clearly were not family-sized farms.

Almost 100 instances of debt forgiveness exceeding $1 million have already been approved, either through write-down or write-off. This includes eight cases of more than $2 million in forgiveness. The highest amount so far, Mr. Chairman, was a write-down of more than $5.6 million on a principal and interest debt of almost $10 million. Many more write-downs and write-offs are in process. I am afraid we haven't seen the last of those big numbers.

Senator CONRAD. Mr. Secretary, let me just say on this point, we have asked for an analysis of these cases because obviously they leap out. The question is did the Federal Government recover more by going the route of restructure than we would have through foreclosure?

Mr. VAUTOUR. That, I cannot answer, Senator. We certainly will try to get that information and furnish it to you.

Mr. JOHNSON. We made efforts to that end in the letter that we brought you just prior to coming here.

Senator CONRAD. I think that really is terribly important for us to understand on each of those cases, because that's what the law requires, and if we are not getting more recovery through write-down than through foreclosure, then we have an administrative problem, it would seem.

Mr. VAUTOUR. Well, Senator, most of those loans were, again, from what you referred to earlier on, the old Economic Emergency loans that once had no dollar limits at all. In fact, there are a couple cases where there are people who owe us millions and millions of dollars who are in this position now. But that particular loophole has been closed for loans that are made today.

Senator CONRAD. The biggest part of our problem for the future are those loan programs Congress, to their credit—again, that was before I came here, so I can't say I was a part of it—but to their credit, Congress ended those programs, and that's the biggest part of our problem for the future.

But it goes back to the central question: Did the Federal Government recover more, which is the intent of the act, by writing down these large loans than we would have if we'd have gone to foreclosure? It is required under the act that we go through a set of calculations to determine how we would recover the most. So the question remains on those large loans: Did in fact we do what the act requires, and if not, why not?

Mr. VAUTOUR. Well, we did what the act requires, for sure, and whether or not we would have gained more by cutting them off at $250,000 or going the route that we have at this point, I don't think I'm capable of answering at this point. But I would like to point out that the average write-down of the family farmer is substantially under the limitation that we are proposing, and that most of these big write-downs were not family farms.

And again, in the spirit and the intent of my testimony here today, the recommendations that we are making are to improve the integrity of the act and certainly the public perception of same. And when we write-down $5 and $6 and $8 and $10 million, the act itself can come into some serious disrepute.

Senator CONRAD. Isn't that really what we're talking about? It seems to me if, in fact, we are recovering more for the Federal Government by restructuring these large loans than by foreclosure, that makes economic sense for the Federal Government. That's just good sense. If the borrower that you've loaned the money to has lost the money—and you get $2 million on a $4 million loan by forgiving some of the debt, and by foreclosure you'd only get $1 million, then its just good business to go out there and provide debt forgiveness. It is not pleasant, and it sure as hell looks bad, but it's good business.

Then we have the question as to the tension between public perception of debt forgiveness—because obviously, when you have a million-dollar write-down, that's big news; a $5 million write-down is really big news. It grates on all of us. It makes me angry. It makes me damned mad, because I'm paying my debts. I'm paying every penny of interest, and I'm paying down the principal. I might have to dip into my own pocket to do it, but I am doing it.

So it grates on me, too, because it is not fair. But the bottom line here, too, is business, and a good business principle for the Federal Government is to get the most we can get.

So the question is are we accomplishing that with the act, and if not, do we have an administrative problem, or do we have statutory problems that we need to correct?

Mr. VAUTOUR. Usually, Mr. Chairman, that figure ends up being pretty much the same whether we write-down or whether we liquidate; we write-down the debt to the level that we would have gotten had we liquidated. So in most cases with these big ones, it would be just about a wash.

Senator CONRAD. OK. That's an important piece of testimony.

Let me just say, after this grilling I have given you, that I personally agree. I think we are going to have to limit the amount of write-down. I think we're going to have to do that for public perception's sake, if nothing else. But public perception is important. If the American people don't want to support this kind of thing, even though it may make good business sense for us in the collective sense to do that, we have to address that.

Mr. VAUTOUR. Unfortunately, Mr. Chairman, nobody every said Farmers Home always had good business sense.

Senator CONRAD. No. One of the things we have tried to bring to the table is how we clear up these problems and get maximum recovery for the taxpayer. That is not an easy trick when you have this portfolio of delinquency out there.

Mr. **Vautour**. Let me, if I might, just finish this paragraph.

The average of all write-downs was $172,857 and the average for write-offs was $205,674. Most borrowers would be unaffected if the maximum amount that could be forgiven was set at $250,000. This would correspond more closely to loan limits that Congress imposed several years ago when abuses developed in the program.

WE RECOMMEND

We recommend to limit the amount of debt forgiveness under write-down and write-off to $250,000 for any one borrower.

Senator **Conrad**. Do you have any estimate of how much that would cost the Federal Government?

Mr. **Vautour**. Do you mean under——

Senator **Conrad**. If we had the limitation. Obviously, if we had the limitation there would be a loss to the Federal Government to do that.

Mr. **Vautour**. The most reliable figures I could give you would be to go back and take the write-downs that we actually did and limit those to $250,000 and tell you how much we would have saved in the process—and we will do that for you.

Senator **Gorton**. But the question is would you have ended up losing more if you could not have written down those that were more than $250,000 and thereby presumably would have to foreclose?

Mr. **Vautour**. It would be a wash, because we would write down to the level of what we would have recovered had we liquidated. But let me say that if we would limit that write-down to $250,000, we probably would take a bigger loss, but we would have known that in the first instance, so I guess really my viewpoint is that with this loan limitation, whether at $1 million or $2 million write-down, we think the Government is going to come out pretty much the same.

Now, the farmer is not. But the perception to the public, in my judgment, is worth that.

Senator **Conrad**. I agree with you on the perception question. But let me go back to the question I asked, because I think it is very important. There should be a cost to the Federal Government if we limit debt forgiveness because the whole purpose of the Agricultural Credit Act was to provide debt forgiveness only when that action saved taxpayers money. In other words, taxpayers would get less money from foreclosure. So if we are going to limit that now, there should be some cost to the Federal Government. Otherwise the current act is not being administered properly or there is some defect in the law, because the whole goal was to get maximum recovery for the Federal Government. If now we change the law to say we are only going to get maximum recovery for the Federal Government on losses below $250,000, then we must be saying the Federal Government is going to lose some more.

Mr. **Vautour**. Sox, perhaps you want to address that.

Mr. **Johnson**. With the limit, once we limit it to $250,000, which we are recommending, obviously you are going to have some people now who are not going to qualify for the net recovery value. So those people are going to drive the system, and it would be accelerated, or they would take bankruptcy probably is what they will do.

Senator CONRAD. Well, that's the question—how much will we lose on that transaction?

Mr. VAUTOUR. Again I would think that we're going to be pretty much the same, the number that would have had net recovery value as opposed to those who would take bankruptcy, because theoretically the law would have had that net recovery value as roughly the same as if they were to take bankruptcy because we were doing the full write-down plus covering all the court costs, lawyer cost, and all those things relating to it.

Senator CONRAD. All right, let's proceed.

USE OF OTHER ASSETS

Mr. VAUTOUR. FmHA is not expressly authorized by statute to look at other assets such as other farm or nonfarm real estate and other nonliquid assets when considering a write-down. We consider those assets in debt settlement, but not in restructuring. The result is inequitable because we are forgiving large debts that borrowers could repay us by the use of those available assets.

WE RECOMMEND

We recommend taking into account all assets of a borrower, in addition to those securing a loan, in determining the write-off and the write-down level.

There are several examples that could be used. For example, if somebody's rich uncle dies and leaves them $100,000 or $200,000 or whatever the figure is, we are not at the present time capable, unless that was in our debt instrument and in our security instrument, we are not able at this point to call on those assets to limit the size of the write-down.

Senator GORTON. Mr. Secretary, how careful is this language? Your written statement and the way you read it said "FmHA is not expressly authorized by statute to look at other assets". Does that mean that you have a legal opinion that you cannot do so, that you must have statutory authority before you can do this?

Mr. VAUTOUR. Senator, I would ask Mr. Steve Babcock, who is counsel for Farmers Home, if he would address that issue.

Mr. BABCOCK. Mr. Chairman, my name is Stephen Babcock, Office of the General Counsel. I am Associate General Counsel for Community Development at the Department of Agriculture. I head the division that advises and represents Farmers Home Administration.

I think your question was whether or not we have advised the agency that they could take into account a borrower's other assets in computing the write-down under the Agricultural Credit Act; is that correct, sir?

Senator GORTON. That's correct.

Mr. BABCOCK. The answer is that the statute does not expressly give them that authority. We have told them that, as their regulations now read, they could not do that except in extremely unusual circumstances in which it was apparent that the retention of the other assets or the purchase of the other assets might have had something to do with creating the delinquency.

We have also advised them——

Senator GORTON. Again, you have said—well, maybe you are going to answer that right now—that under their present regulations, they cannot go beyond that. If they were to revise their regulations, would those revisions be valid?

Mr. BABCOCK. It is not clear, sir. What we advised them is that, if they wanted to correct this problem, the first thing to do would be to go up to the Congress and try to get clear statutory authority.

Senator CONRAD. Could I just pursue that?

Mr. BABCOCK. Yes, sir.

Senator CONRAD. I'm at a loss on this one, I really am. Number one, the law says "circumstances beyond the borrower's control". Now, it is not beyond the borrower's control that he is not paying what he owes if he's got $500,000 off in an account somewhere. That guy owes them money, and he ought to be compelled to draw on that money.

I look at the specific language that you all have used here: "The second question you have asked us to address is whether FmHA must ignore a borrower's other assets when the agency has no lien on them in computing the write-down."

Here is what you say: "Here, our advice has been less definitive since the considerations are much more complex."

I don't know why you don't err on the side of protecting the taxpayer here and say we do have the authority to look beyond the smokescreen and to insist that those other assets be included.

It is no one's intention—it is not your intention, it certainly wasn't Congress' intention—to allow some guy to have a potful of money over here and not have to have it considered. That's why the law is written the way it is. If it is "circumstances beyond their control", that is what is supposed to allow them to qualify. If it is not beyond their control they ought to pay their bills like the rest of us are expected to do.

Why is there not an attempt to put into regulation what Congress clearly intended?

Mr. BABCOCK. Well, Mr. Chairman, let me respond two ways to that. First of all, my division's advice to the agency has not been in general to interpret the law to obtain absolute maximum return to the taxpayers in all circumstances; far from it.

This agency got itself into terrible problems judicially in the past, in part through doing just that, and we have tried to give the agency advice that we think cuts it right down the middle. We try to follow the middle road on interpreting the statutory guidance that Congress gives the agency. We do not try to induce a bias either in favor of the taxpayer, which is against the borrower, or against the taxpayer and in favor of the borrower.

Now, more particularly, let me respond to your question. What the statute says is that a borrower cannot get a write-down if his delinquency is due to circumstances beyond his control. Now, let's take an example of a borrower who had an emergency loan, let's say, some years ago, and he was making payments, and in fact one year he even made a little extra and he bought himself $10,000 worth of stock in the local power company, which pays about 7–8 percent and has been paying it ever since he bought it. Then, 2 or 3 years later, they had a drought in his State; the next year they had another drought, and the next year, they had a third drought. The guy is broke. He says, "I lost my money the old way, farming. The Power Company is still paying their 8 percent, and we are figuring that into my financials, but my delinquency is due to bad weather; it is not due to the fact that one year I made a little more, and I bought some stock."

The second problem——

Senator **Conrad**. Before you go to the second problem, let me just ask you this because you have raised a specific example. Let's take the example that is in the Secretary's testimony. Somebody inherits a potful of money and owes $100,000 but has $500,000 over on the side. Why in goodness' name don't we go after that guy for the $100,000 he owes? It is certainly not "circumstances beyond his control" that causes his delinquency on the $100,000 if he's got half a million bucks he inherited from his rich uncle.

Mr. **Babcock**. Again, it depends on how you interpret the statute. In that case, again, it may well be that the delinquency was caused by circumstances having to do with his farming operation.

Now, I must say we have not told the agency that there are not circumstances, especially these most egregious cases that you are talking about—if they exist; we hear stories, but we aren't sure how many they are—we certainly would not tell the agency that they could not refuse a write-down in such a circumstance, after checking with local counsel to make sure that there wasn't a problem with State law, because in some States you have to elect what remedy, and it gets really complicated.

But let me go back to what I said before. We have not told the agency that they could not initiate a rulemaking and see how far we could reasonably expand on the circumstances beyond the control of the borrower and on the Secretary's general authority to enact such regulations as the Secretary deems appropriate in administering the act. But what we have told them is they have no clear authority; the Ag Credit Act enacted a formula which does not take into account these other assets. And the simplest way to clear up the problem is to get specific congressional guidance. That is what we have told them.

Senator **Conrad**. All right.

Mr. Vautour.

INVENTORY PROPERTY

Mr. **Vautour**. We currently must offer inventory property at what is called "capitalization value" or market value, whichever is lower, to borrowers exercising buyback rights. Now, "capitalization value", so far as I can determine, is prescribed only in the Food Security Act of 1985. It applies only in the sale of farmland in FmHA's inventory, to operators of not larger than family-size farms under this statute. Capitalized value may have little relationship to the true market value, particularly for land in or near developing areas. And I would add as a parenthetical statement that in most cases in the Midwest and in the Grain Belt, capitalization and fair market are pretty close. For instance, under the capitalization value concept, we value land at a price that reflects the average annual income that might reasonably be expected from its farming operation. With the rapid growth in some parts of the country, some land is worth many times that because of its location or alternate uses. Selling at "capitalization value" gives the buyer a windfall at taxpayers' expense.

For example, if an inventory farm must be irrigated to produce agricultural commodities, but the cost of irrigation exceeds the value that those commodities will return, the capitalization value for that farm is zero.

One such farm in our inventory is close to a rapidly urbanizing area near Phoenix. It consists of more than 400 acres with a present market value of $30,000 an acre for industrial use, a total value of $1.2 million—a real windfall. Under current rules that borrower stands to make a fortune on property that we are supposed to "sell" back to him for virtually nothing.

Also, much confusion is caused by the requirement that the County Committee select from among eligible applicants the one with the "greatest need" for farm income and is "best qualified" under FmHA eligibility standards. Often, all applicants feel they are most qualified, and this causes hardship and disappointment among bidders and frustration for County Committee members.

The result is successive appeals for the multiple contenders for the property. The administrative appeal process can protract the sale for months.

WE RECOMMEND

We recommend:

One, that we offer property to purchasers with buyback rights at the appraised market value, not "capitalization value".

Two, allow use of random selection for cases decided by the County Committee.

Senator **Conrad**. Let me just say that clearly we want to close that loophole, and I commend you for bringing that to the attention of the committee. I can assure you something along those lines is going to be in the bill. We have to close that off.

The whole question of how you select a successful bidder is a difficult one. I will tell you we have a problem now where you have people who lost the early decision appeal, and then the National Appeal Staff reverses that decision, and then the guy who was the original choice appeals. We have to find a way to short-circuit that.

Let me ask you why don't we just have a bid process and once they identify five people, for example, who would all qualify, let whoever is the highest bidder——

Mr. **Johnson**. That would essentially get you back to the market value, obviously, if you did that. Our approach there, regardless of whether we take bids or sealed bids or by what method we might use to dispose of it, is to get to the market value, and that's what you've just suggested. That is one technique for getting there. We have left it more general by saying——

Senator **Conrad**. Well, there is an argument against doing it the way I have suggested. The argument it is we're trying to get it in the hands of the beginning farmer, and if you go out there and sell it at market value, you start the whole cycle of not being able to cash-flow it, and you've guaranteed a failure.

On the other hand, the fact is you have a process where somebody's got to get that land. How do you decide whose hands it goes into? It is a very, very delicate issue and leads to very hard feelings. Other witnesses will no doubt comment on this, but I myself am not yet convinced that we shouldn't just use a sealed bid process.

Mr. JOHNSON. We think we have the process to achieve. It is a matter of using the market value I think is the key thing there, because the process we use now, by appraising, we can let them come in as long as they are a family farm and negotiate with them; then, if not, we use the sealed bid process.

Senator CONRAD. All right.

INADEQUATE DEADLINES

Mr. VAUTOUR. Finally, Mr. Chairman, the matter of inadequate deadlines. You are looking at a fellow who has gathered some considerable scar tissue on this issue.

A tremendous benefit would be provided to borrowers and FmHA's ability to assist them would be greatly improved by the extension of certain key deadlines in the act. Appeals would be reduced and final loan decisions could be made earlier.

WE RECOMMEND

We recommend giving the borrower 60 days rather than 45 days to submit applications after receiving notice of loan servicing availability; 90 days rather than 45 to arrange buyout financing; and give FmHA 90 rather than 60 days to process loan servicing applications.

CONCLUSION

Mr. Chairman, we would be happy to work with you on legislation to bring about these changes. Working together, we can close these loopholes. And I would just like to reiterate for the record, and so that everybody clearly understands our motives behind all of this is to preserve the integrity of the act, to close loopholes or anomalies, if you want to call them that, that have evolved through the administration of this act, but certainly are not intended to gut the act or to do away with it, but to make it a much leaner and I think more efficient and a more equitable act.

With that, I thank you for the opportunity to express our views.

[The prepared statement, and attached chart and table of Mr. Vautour follow:]

TESTIMONY OF

ROLAND R. VAUTOUR, UNDER SECRETARY
SMALL COMMUNITY AND RURAL DEVELOPMENT
UNITED STATES DEPARTMENT OF AGRICULTURE
Before the
SUBCOMMITTEE ON AGRICULTURAL CREDIT
SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
March 5, 1990

Thank you, and good morning, Mr. Chairman and Members of the Committee. I appreciate this opportunity to be here today to report to you on our experience in carrying out the Agricultural Credit Act of 1987.

Our debt restructuring efforts are continuing with a notable degree of success. Since the Act was implemented, we have mailed notices of servicing options to 75,352 FmHA farm borrowers who were 180 days delinquent. Of that total, we have been able to resolve the accounts of 32,548 borrowers, leaving 42,804 unresolved as of Nov. 30, 1989.

Let me discuss the latter category first. The figure includes 4,774 cases of mediation pending or yet to be resolved; 3,297 accelerated accounts pending disposition; 2,452 lease-back/buy-back and homestead protection options; and 32,281 in the "other" category. That includes appeals, bankruptcy, servicing actions not yet completed, and borrowers who have not recponded to the notices.

Of the 32,548 resolved accounts, 4,593 were paid current; 1,424 were paid in full; 6,341 borrowers had their debt settled through one of several means; 920 were liquidated through sale, assumption, voluntary conveyance or foreclosure; 34 were prosecuted by the Department of Justice, and 19,236 received primary servicing.

Primary loan servicing actions included 9,599 reschedulings, reamortizations, consolidations and deferrals; 4,608 debt restructuring with write-downs for more than $796 million, and 5,029 buy-outs at net recovery value which involved a write-off of $1 billion.

The 6,341 debt settlements included many cases where the security had been liquidated but indebtedness had not been written off. Those settlements totaled $933 million in debt write-offs.

When you add that $933 million to the $796 million in write-downs and $1 billion in buy-outs, you have debt forgiveness amounting to almost $2.8 billion for 15,978 borrowers. That is an average of $172,600 per borrower.

I am attaching for the record some tables relative to those actions, including one with State-by-State figures.

In summary, Mr. Chairman, we are making progress on the loan servicing front. Our field staff has put forth a tremendous effort in this regard, while maintaining their workload in housing and other duties.

Now I would like to discuss some of the problems we have encountered with the Ag Credit Act, problems that no one anticipated when the Act was passed. Nevertheless, they are adding to the taxpayers' burden while making it possible for a small number of borrowers to abuse this program.

Mr. Chairman, we have an opportunity and a responsibility to correct those problems, and I believe it is imperative that we do so. We estimate that the cost of debt restructuring under the Ag Credit Act alone will amount to more than $8 billion. When you add interest subsidies, write-offs not attributable to the Ag Credit Act, and other expenses, we are looking at overall losses in our farm programs of something more than $22 billion over the next several years!

We all have a responsibility to keep those losses as small as possible. We in the Administration certainly have a responsibility to let you know whenever we run into loopholes in the law. We have an equal responsibility to suggest ways to close those opportunities for abuse.

Mr. Chairman, I would like to list several problems we have found in the Act and then discuss them and give you our recommendations. The problems:

1. Net recovery buy-out: It is too easy for a borrower to make a financial windfall under the present statute.

2. Good faith : An opportunity exists for bad faith dealings.

3. Limits on restructuring: A borrower could return for unlimited write-downs under existing language.

4. No limit on loans eligible: Under present law, loans being made today, and in the future, would be eligible for restructuring, including write down.

5. Limits on debt forgiveness: Huge amounts are being forgiven because there is no dollar limit in the law.

6. Use of other assets: Many borrowers have assets that could be used to reduce their debt, if they were required to use them.

7. Inventory property: Current law gives windfalls to some farmland purchasers.

8. Inadequate deadlines: Borrowers and FmHA have insufficient time to consider options and process applications.

Now, let me go over those points in more detail.

Net recovery buyout. In net recovery buyout, the borrower is given an opportunity to buy out the loan at the current market value of its existing security minus prior liens and costs associated with acquiring, maintaining and disposing of inventory property.

This option is available to borrowers who do not qualify for loan restructuring with debt write-down. The recapture period is only two years compared to 10 years for a write-down, and there is no recapture of appreciation for buy-outs. There is no prohibition against selling the property for the same price, or less, than the buy-out price -- and on the same day, at that, and we would not recapture if there were a subsequent sale.

We recommend: 1) Require sales to be conducted at arm's length or have recapture computed on appraised market value at time of sale even if the sale is for less than the market value, and 2) extend the recapture period for buyouts to 10 years, the same period as write-downs.

Good faith dealing. Borrowers who have not acted in good faith -- such as those who convert security -- are still eligible for the buy-out option even though the statute makes them ineligible for write-downs. (In write-downs, the amount of debt can be reduced to the net recovery value of collateral if that restores the cash flow ability of the borrower.)

This could encourage conversion, which, in our case, usually means the sale without our knowledge or consent of crops, livestock, or equipment on which we have a lien. We have been required to offer buy-outs to borrowers who have failed to deal with us in good faith.

An example, from Wyoming, involves a borrower who disposed of property on which FmHA had a lien and did not apply any of the proceeds to the debt. This resulted in an immediate monetary loss of $251,814. Even though FmHA was able to document the facts in the case, the borrower still has the net recovery buy-out option. If that option is exercised, FmHA will be required to accept $45,361 as the net recovery buy-out based on the remaining asset value, in full settlement of the debt, and take an additional loss of $340,924, for a total loss of $592,738.

Another case, from Minnesota, involved three members of a family who have disposed of FmHA-mortgaged property for which they received more than $500,000 and FmHA received nothing. They still qualify for net recovery buy-out, which would result in debt forgiveness of $1.75 million, if approved, meaning an overall loss to the taxpayers of over $2.2 million. These are only two of a number of cases.

+ We estimate the cost of bad faith transactions alone to be more than $88 million to the Government, that is, to the taxpayers.

We recommend: Impose a good faith requirement, the same as now applicable to debt write-down, on net recovery buy-out transactions and preservation loan servicing actions. Allow FmHA to value all assets originally pledged, even if they have been converted by the borrower.

Limits on restructuring. A borrower should be limited to one restructuring with write-down. The Ag Credit Act imposes no limitation in this regard, and this raises the very real possibility that a borrower could receive a write-down, again become delinquent and go through the entire process again.

Multiple write-downs could easily occur if the net recovery value of the security continued to decline, as in the case of chattels, so that, with each restructuring calculation, its net recovery value would be less than the value of payments on the newly restructured loan. It is not appropriate to regularly reduce loans when the value of security such as tractors and the like diminishes. Repayments should match depreciation schedules.

In addition to reducing any incentive for a borrower to remain current on loans, this perpetual availability of write-down would continue to cost the taxpayers. An important, though unfortunate, result would be the clear and strong message to other borrowers that this approach encourages continuing delinquency. One opportunity allows a good farmer to recover from his problems and get a clean start.

We recommend: Limit loan restructuring with debt write-down to one such action per borrower.

No limit on eligibility. Under present law, borrowers with loans made at any time, including the last two years when net farm income was near record levels, could let their payments slide and, yet, be eligible for loan servicing under the Act. This does not provide encouragement to borrowers to keep their loans current.

We believe that Congress's intent was to help those borrowers who suffered financial distress through no fault of their own as a result of the general economic downturn during the mid-1980's.

We recommend: Loans closed after a cut-off date of Jan. 6, 1988, the date the Act was signed into law, would not be eligible for the extraordinary restructuring rights with debt write-down or net recovery buy-out in the 1987 Act. They would continue to be eligible for FmHA loan servicing such as consolidation, rescheduling, reamortization and deferral.

Limits on debt restructuring. The lack of any dollar limitation on the amount of debt that can be forgiven has produced some cases that clearly were hard to believe even though they were legal and required under the Act. These clearly were not family-sized farms.

Almost 100 instances of debt forgiveness exceeding $1 million dollars have already been approved, either through write-down or write-off. This includes eight cases of more than $2 million in forgiveness. The highest amount so far, Mr. Chairman, was a write-down of more than $5.6 million on a principal and interest debt of almost $10 million. Many more write-downs and write-offs are in process.

Those huge loan amounts represent old emergency loans that once had no dollar limits and had continuing eligibility for additional loans. This loophole has been closed for loans made today.

The average of all write-downs was $172,857 and the average for write-offs was $205,674. Most borrowers would be unaffected if the maximum amount that could be forgiven were set at $250,000. This would correspond more closely to loan limits that Congress imposed several years ago when abuses developed in the program.

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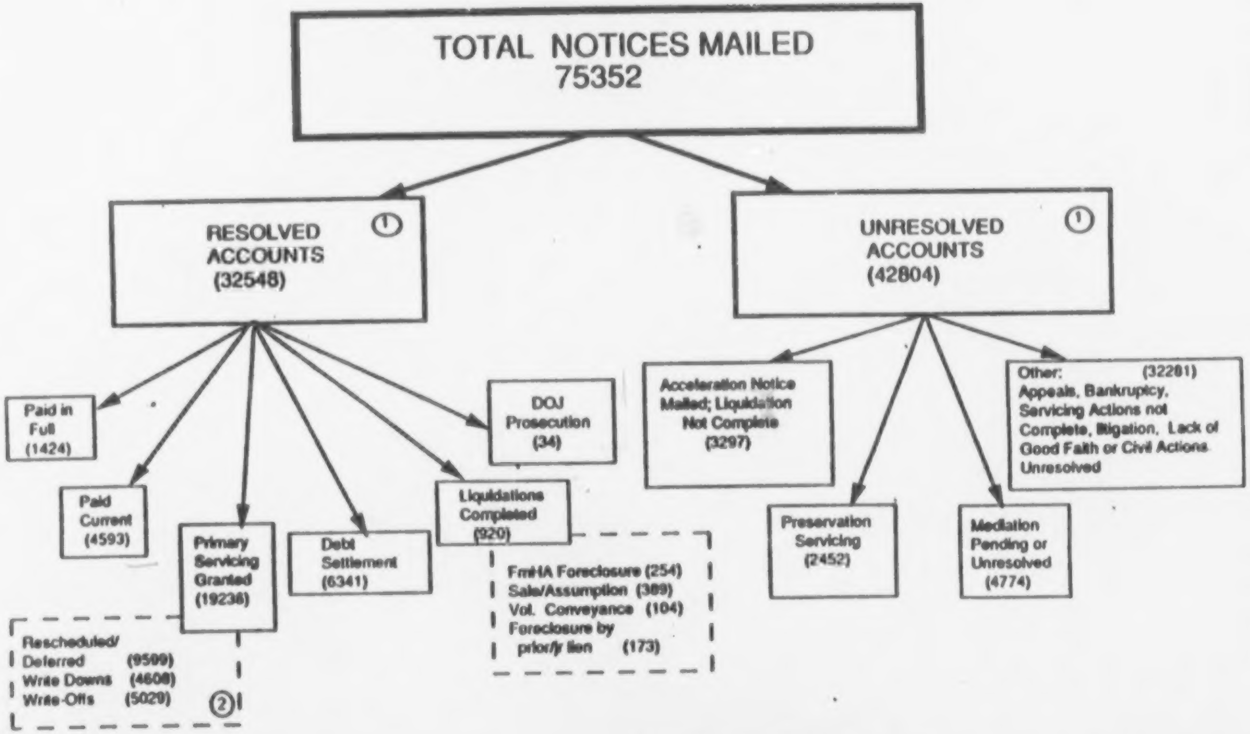
We recommend: Give borrowers 60 rather than 45 days to submit applications after receiving notice of loan servicing availability, 90 days rather than 45 to arrange buy-out financing, and give FmHA 90 rather than 60 days to process loan servicing applications.

Mr. Chairman, we would be happy to work with you on legislation to bring about these changes. Working together, we can close these loopholes, which were, I am sure, unintended by Congress, without damaging legitimate assistance for farmers in need who act in good faith.

This completes my formal statement. I will be glad to answer any questions you might have. Thank you.

FmHA LOAN SERVICING ACTIVITY THRU 11/30/89

Agricultural Credit Act of 1987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UNRESOLVED ACCOUNTS (42804) ①
Paid in Full (1424)
Paid Current (4593)
Primary Servicing Granted (19236)
Debt Settlement (6341)
Liquidations Completed (920)
DOJ Prosecution (34)
Rescheduled/Deferred (9599)
Write Downs (4608)
Write-Offs (5029) ②
FmHA Foreclosure (254)
Sale/Assumption (389)
Vol. Conveyance (104)
Foreclosure by prior/jr lien (173)
Acceleration Notice Mailed; Liquidation Not Complete (3297)
Preservation Servicing (2452)
Mediation Pending or Unresolved (4774)
Other: (32281)
Appeals, Bankruptcy, Servicing Actions not Complete, litigation, Lack of Good Faith or Civil Actions Unresolved

1. Includes Borrowers who failed to respond.
2. Write-Offs are Net Recovery Buyouts.

tbl:1/22/90

FARMERS HOME ADMINISTRATION LOAN SERVICING ACTIVITY AS EMBER 30, 1989
AGRICULTURAL CREDIT ACT 1987

Compiled by: FMHA/FP/POS
1/7

STATE	TOTAL NOTICES SENT	TOTAL RESOLVED ACCOUNTS	PAID IN FULL	PAID CURRENT	PRIMARY SERVIC'G GRANTED	RESCH/ DEFER.	RESOLVED ACCOUNTS – WRITTEN DOWN – NUMBER BORROWERS	DOLLAR AMOUNT	AVG. PER BORROWER	RESOLVED ACCOUNTS – WRITTEN OFF – NUMBER BORROWERS	DOLLAR AMOUNT	AVG. PER BORROWER
ALABAMA	956	859	23	112	426	231	66	9,187,073	139,198	129	22,357,592	173,315
ALASKA	4	2	0	1	0	0	0	0	0	0	0	0
ARIZONA	457	127	8	19	53	42	5	14,348,578	2,869,716	6	3,124,619	520,737
ARKANSAS	2,010	826	36	62	640	287	131	29,279,149	223,505	222	59,199,553	266,665
CALIFORNIA	1,495	632	41	158	315	211	54	17,765,689	328,994	50	22,776,530	455,531
COLORADO	965	288	10	8	171	97	38	5,841,834	153,732	36	8,591,534	238,654
CONNECTICUT	52	26	4	10	12	12	0	0	0	0	0	0
DELAWARE	45	19	1	7	7	5	1	223,584	223,584	1	502,407	502,407
FLORIDA	1,460	434	43	55	211	119	57	8,402,160	147,406	35	18,392,346	525,496
GEORGIA	3,915	1,469	52	231	568	107	131	32,020,822	244,434	250	69,944,585	279,778
HAWAII	115	64	8	15	39	39	0	0	0	0	0	0
IDAHO	1,457	552	38	28	434	228	96	25,565,341	266,306	110	23,369,371	212,449
ILLINOIS	1,602	926	31	28	652	366	159	22,797,097	143,378	127	15,979,470	125,823
INDIANA	2,339	1,071	34	170	625	264	214	35,861,283	167,576	167	31,048,605	185,920
IOWA	2,959	1,255	44	161	752	480	150	17,466,583	116,444	122	18,984,654	155,612
KANSAS	1,747	739	45	73	394	217	92	9,302,376	101,113	85	10,629,269	125,050
KENTUCKY	1,652	900	43	12	718	382	206	22,750,054	110,437	130	22,174,067	170,570
LOUISIANA	4,119	1,623	88	180	1,106	351	183	42,231,035	230,771	572	129,327,020	226,096
MAINE	525	348	19	71	136	64	26	3,174,927	132,289	48	13,782,521	287,136
MARYLAND	299	195	13	8	98	75	7	145,254	20,751	16	1,485,218	92,826
MASSACHUSETTS	56	38	5	10	16	15	1	69,848	69,848	0	0	0
MICHIGAN	1,511	871	25	17	656	303	192	38,673,331	201,424	161	36,711,485	228,023
MINNESOTA	3,982	2,253	63	342	1,251	414	359	48,162,597	134,158	478	81,198,792	169,855
MISSISSIPPI	4,580	1,062	85	67	933	401	201	53,000,442	263,684	331	84,205,771	254,398
MISSOURI	3,141	1,153	41	39	879	374	256	30,877,363	120,615	249	43,014,785	172,750
MONTANA	1,213	528	12	123	350	198	93	25,341,422	272,488	59	15,311,030	259,509
NEBRASKA	1,759	923	45	219	494	244	137	18,462,297	134,761	111	20,973,497	188,950
NEVADA	82	27	1	12	11	7	3	775,988	258,443	1	244,837	244,837
NEW HAMPSHIRE	10	2	2	0	0	0	0	0	0	0	0	0
NEW JERSEY	244	94	12	18	52	52	0	0	0	0	0	0
NEW MEXICO	350	160	12	6	106	77	14	1,553,316	110,951	13	1,525,446	117,342
NEW YORK	1,659	379	26	21	255	183	41	6,386,547	155,769	31	4,006,273	129,235
NORTH CAROLINA	2,103	1,017	88	222	390	205	70	13,744,465	196,350	115	22,359,421	194,430
NORTH DAKOTA	3,309	1,567	39	363	997	431	314	45,975,079	146,417	252	51,597,661	204,753
OHIO	1,281	441	13	128	212	116	31	5,104,425	164,659	67	12,716,998	189,806
OKLAHOMA	3,235	1,525	42	310	980	470	296	61,234,613	206,874	223	40,600,320	182,064
OREGON	992	273	8	32	161	72	45	8,382,385	186,496	44	12,154,745	276,244
PENNSYLVANIA	429	128	5	7	67	38	20	3,201,874	160,094	9	2,032,449	225,828
RHODE ISLAND	10	7	0	4	3	2	0	0	0	1	5,624	5,624
SOUTH CAROLINA	1,092	346	17	72	193	104	31	13,428,522	433,178	58	9,792,659	168,839
SOUTH DAKOTA	2,580	1,472	36	301	994	520	326	41,748,437	128,038	148	22,216,931	150,114
TENNESSEE	2,430	1,210	63	299	649	487	79	12,572,553	159,146	83	13,360,849	161,083
TEXAS	5,335	1,488	46	99	754	401	140	26,087,745	186,341	213	48,375,787	227,116
UTAH	269	147	15	47	72	56	9	477,423	53,047	7	1,500,000	214,286
VERMONT	116	11	4	0	7	7	0	0	0	0	0	0
VIRGINIA	1,117	455	40	135	204	122	40	6,029,341	150,734	42	4,718,357	112,342
WASHINGTON	644	224	11	6	187	114	48	7,857,210	163,692	25	4,456,569	178,263
WEST VIRGINIA	318	158	8	51	83	78	10	1,476,734	147,674	3	73,603	24,534
WISCONSIN	2,607	1,008	40	93	724	350	203	21,033,666	103,614	171	25,429,588	148,711
WYOMING	243	144	7	3	102	42	33	8,566,123	259,579	27	3,987,868	147,699
PUERTO RICO	889	300	46	138	90	87	2	26,293	13,146	1	93,052	93,052
VIRGIN ISLANDS	11	0	0	0	6	0	0	0	0	0	0	0
U.S. TOTAL	75,352	32,548	1,424	4,593	19,236	9,599	6,608	$796,526,800	$172,057	5,029	$1,034,334,726	$205,674

1.

STATE	DEBT SETTLEMENTS NUMBER BORROWERS	 DOLLAR AMOUNT	 AVERAGE PER BORROWER	LIQUIDATION COMPLETE LIQUID COMPL.	 FORCL. COMPL.	 SALE OR TRANSFER ASSUMP.	 VOLUN. CONVEY.	 FORCL. PRIOR/JR LIEN	 DOJ PROSEC.	UNRESOLVED ACCOUNTS TOTAL UNRESOLVED ACCOUNTS	 ACCEL. NOTICE MAILED	 PRESV'N IN PROCESS	 UNRESOLV., PENDING, MEDIATION	 OTHER
ALABAMA	228	35,080,821	153,863	68	51	14	2	1	2	97	12	11	74	0
ALASKA	1	55,503	55,503	0	0	0	0	0	0	2	0	1	0	1
ARIZONA	41	7,481,758	182,482	6	1	1	0	4	0	330	62	47	27	194
ARKANSAS	42	4,451,506	105,988	44	2	31	10	1	0	1186	120	180	14	872
CALIFORNIA	57	13,636,383	239,235	61	17	28	3	13	0	863	147	44	14	658
COLORADO	89	9,471,059	106,416	9	3	1	2	3	1	657	2	40	39	576
CONNECTICUT	0	0	0	0	0	0	0	0	0	26	4	0	0	22
DELAWARE	4	479,836	119,959	0	0	0	0	0	0	26	7	3	0	16
FLORIDA	116	20,266,139	174,708	9	0	2	4	3	0	1026	115	33	17	861
GEORGIA	533	113,395,511	212,750	85	15	62	2	6	0	2446	543	145	87	1671
HAWAII	2	24,910	12,455	0	0	0	0	0	0	51	35	1	0	15
IDAHO	36	4,343,057	120,640	16	3	8	2	3	0	905	20	41	55	789
ILLINOIS	173	16,690,002	96,474	42	0	23	7	12	0	676	30	31	97	518
INDIANA	231	37,375,751	161,800	11	1	8	0	2	0	1268	153	39	55	1021
IOWA	269	20,833,597	77,448	27	9	6	0	4	0	1706	48	208	315	1133
KANSAS	203	22,740,310	112,021	20	1	6	1	12	4	1008	81	36	84	807
KENTUCKY	116	11,857,666	106,015	13	0	10	0	3	0	752	56	53	42	601
LOUISIANA	255	95,071,997	372,831	0	0	0	0	0	2	2496	103	92	77	2224
MAINE	119	11,001,580	92,450	3	2	1	0	0	0	177	23	16	3	135
MARYLAND	70	7,407,406	105,820	6	4	2	0	0	0	106	16	10	7	71
MASSACHUSETTS	6	641,359	106,893	1	0	0	0	1	0	18	5	0	0	13
MICHIGAN	162	25,223,447	155,700	11	1	5	2	3	0	640	17	38	46	539
MINNESOTA	586	42,416,503	72,383	10	0	5	0	5	1	1729	113	101	482	1033
MISSISSIPPI	713	113,459,380	159,130	44	6	34	22	2	0	2718	49	154	428	2087
MISSOURI	140	13,522,357	96,588	53	24	29	5	4	1	1988	12	136	182	1658
MONTANA	34	4,598,475	135,249	9	0	2	6	3	0	685	32	28	110	515
NEBRASKA	130	15,124,838	116,345	31	15	15	0	1	4	836	98	43	69	626
NEVADA	3	132,171	44,057	0	0	0	0	0	0	55	0	5	1	49
NEW HAMPSHIRE	0	0	0	0	0	0	0	0	0	8	0	0	0	8
NEW JERSEY	12	502,539	41,878	0	0	0	0	0	0	152	10	5	3	134
NEW MEXICO	35	4,016,725	114,764	3	0	2	0	1	0	190	13	21	23	133
NEW YORK	71	7,661,064	107,902	6	1	1	0	4	0	1280	16	91	72	1101
NORTH CAROLINA	263	56,849,783	216,159	59	35	16	3	5	3	1086	198	52	104	732
NORTH DAKOTA	138	17,240,898	124,934	26	2	6	1	17	4	1742	237	38	463	1004
OHIO	75	14,682,219	195,763	13	0	9	0	6	0	840	56	37	42	705
OKLAHOMA	158	16,470,028	104,241	22	9	5	2	6	4	1710	99	59	405	1147
OREGON	43	4,438,161	103,213	29	0	3	2	24	0	319	35	15	18	251
PENNSYLVANIA	49	8,510,663	173,687	0	0	0	0	0	0	301	14	16	9	262
RHODE ISLAND	0	0	0	0	0	0	0	0	0	3	1	0	0	2
SOUTH CAROLINA	56	10,356,076	184,930	6	0	3	2	1	2	746	44	29	42	631
SOUTH DAKOTA	111	8,777,777	79,079	30	13	9	4	6	0	1108	102	66	300	640
TENNESSEE	165	18,447,303	111,802	33	6	15	11	1	1	1220	310	108	94	708
TEXAS	555	86,346,068	155,579	33	13	18	1	1	1	3847	69	169	462	3147
UTAH	7	807,252	115,322	6	4	1	0	1	0	122	5	7	5	105
VERMONT	0	0	0	0	0	0	0	0	0	105	0	3	1	101
VIRGINIA	69	12,930,607	187,400	6	4	2	0	0	1	662	39	70	47	506
WASHINGTON	10	808,737	80,874	8	0	3	1	4	2	420	17	31	15	357
WEST VIRGINIA	7	388,578	55,511	1	1	0	0	0	0	168	21	5	10	132
WISCONSIN	124	11,961,112	96,461	18	0	10	1	7	1	1607	48	92	283	1184
WYOMING	26	5,046,675	194,103	6	1	0	0	5	0	99	0	11	46	42
PUERTO RICO	10	90,036	9,004	16	10	2	2	2	0	589	60	11	5	513
VIRGIN ISLANDS	0	0	0	0	0	0	0	0	0	11	0	0	0	11
U.S. TOTAL	6,341	$933,115,392	$147,156	920	254	399	104	173	34	42,804	3,297	2,452	4,774	32,281

Senator **Conrad**. Thank you very much, Mr. Vautour.

I think we have been through a good process of getting the questions on the table. Let me just say on the last point you made that we have a complete meeting of the minds. Those deadlines do need to be changed to allow the whole process to work more efficiently. It is clear we can get that done—and many of the suggestions that you offer I think are very positive, very constructive things that we can put into law.

There are other places where we disagree. On the one hand, you say the Agricultural Credit Act has worked and has been a good tool, but one of your proposals is to cut it off with a cut-off date. I personally think that would be a mistake, frankly. I'm not insensitive to the issue you raise and what you are trying to get at. I think all of us have an interest in solving the specific problems you have identified.

Mr. **Vautour**. Mr. Chairman, if there are no further questions of me, I have another appointment that I really should make. I will ask Sox and Mr. Babcock and members of the staff of the Farmer Programs Division to remain here. If it is all right with you, Mr. Chairman and Mr. Gorton, I would appreciate taking my leave.

Senator **Conrad**. All right. We appreciate the time that you have spent with us and your thoughtful testimony. We have appreciated the chances we have had to discuss these issues on the telephone and in person. We fully intend to work together and move through this legislation.

Mr. **Vautour**. I appreciate that, Mr. Chairman. And as to whether we agree on every issue, I guess I would merely quote you an old New Englandism, if I may be permitted, and that is that when two men agree, one is unnecessary.

Thank you.

Senator **Conrad**. Thank you. There is certain wisdom in that—that's why we have 535 Members of Congress.

Mr. **Vautour**. Thank you again.

Senator **Conrad**. Thank you.

Next, we'll hear from James Ebbitt, the Assistant Inspector General for Audit, Office of the Inspector General of USDA.

Welcome, and please proceed.

STATEMENT OF JAMES R. EBBITT, ASSISTANT INSPECTOR GENERAL FOR AUDIT, OFFICE OF THE INSPECTOR GENERAL, U.S. DEPARTMENT OF AGRICULTURE, WASHINGTON, DC; ACCOMPANIED BY RICHARD DAVIS, DIVISION DIRECTOR, RURAL DEVELOPMENT AND NATURAL RESOURCES DIVISION

Mr. **Ebbitt**. Thank you very much, Mr. Chairman and Senator Gorton.

INTRODUCTION

I am James R. Ebbitt, the Assistant Inspector General for Audit, and with me this morning, on my right, is Richard Davis, who is the Division Director of our Rural Development and Natural Resources Division, our division that handles Farmers Home Administration. We are pleased to be here today to discuss our audit work, and I would like to submit my full statement for the record and just summarize the main points.

OIG UNDERTOOK A PREVENTIVE AUDIT APPROACH

Due to the large dollar magnitude of the program, with write-offs or write-downs estimated by FmHA at about $8 to $10 billion, and its inherent vulnerability to additional losses, we have undertaken a preventive audit approach. First, we performed an independent evaluation of the debt restructuring regulations as soon as they were available in draft form.

Next we assessed the software program, called "DALR$", developed by FmHA to perform debt restructuring computations and to facilitate the servicing actions. We then reviewed the adequacy of the borrower notification process.

As the first debt restructuring applications were being processed, we performed an analysis at five State and five county offices of FmHA's methodology in order to identify potential weaknesses which could hurt the program as a whole. During this phase of our audit we issued a total of eight reports which disclosed issues that warranted prompt action by management. I might add that FmHA worked very well with us and we had a good dialog back and forth as to how to correct the deficiencies that we found. Among the findings we identified was the impact of tax liabilities in borrowers' estimates of future financial position. We noted an example wherein a borrower received an excessive write-off of $160,000 due to an error in this area.

ONE OF OUR MORE SIGNIFICANT FINDINGS

One of our more significant findings thus far, however, has been our disclosure of the loophole in the act, which you and Under Secretary Vautour have been discussing, which permitted borrowers who had not acted in good faith to participate, without recourse, in the net recovery buyout option. Borrowers who had illegally disposed of security property were, in essence, not only able to obtain immunity from prosecution, but to directly gain monetary benefits from the perpetration of the fraud. FmHA has compiled statistics that showed over 280 borrowers with write-offs totaling nearly $70 million had wrongfully taken advantage of this discrepancy. We recommended that legislation be sought to rectify this condition and that measures be pursued to add-back the value of any improperly disposed property. You have been discussing that legislation, Mr. Chairman, and it is moving in the House as well, to close this loophole. We strongly endorse prompt passage of the legislation containing this provision.

Senator CONRAD. We appreciate that. As you know, we passed it here in the Senate last year, and I am told reliably that the House will do the same. So that loophole will be closed. I very much appreciate the work that you have done in bringing it to our attention and the work of FmHA to bring it to our attention as well.

Sox, did you want to comment?

Mr. JOHNSON. I believe we do have one problem with it over the Sunset provision. That was included in that final bill, wasn't it? That was the one concern that you and I had discussed that we do have concern about. We felt it should be permanent legislation; otherwise, we applaud the effort.

Senator CONRAD. We're going to have a chance to revisit that when we go back to the drawing board on this one.

NATIONWIDE REVIEW OF THE PROPRIETY OF THE WRITE-DOWN AND WRITE-OFF ACTIONS

Mr. EBBITT. In January of this year, Mr. Chairman, we embarked upon a nationwide review of the propriety of the write-down and write-off actions. This work is being performed in 11 States and is emphasizing large dollar transactions—borrowers who had received write-offs or write-downs of $1 million or more. We are concentrating on the possibility of illegal or improper schemes or devices to take advantage of the program.

YOU REQUESTED US TO ANALYZE THE LOAN HISTORIES OF THOSE BORROWERS WHO HAD RECEIVED THESE LARGE WRITE-DOWNS OR WRITE-OFFS

On November 1, 1989, Mr. Chairman, you requested us to analyze the loan histories of those borrowers who had received these large write-downs or write-offs of $1 million or more. Although we will be providing a formal report to you on the results of this review very soon, we can at this time provide a summary of our responses to your questions.

The 74 borrowers in our sample who had received more than $1 million in write-downs or write-offs had received a total of 639 loans with original loan amounts of over $119 million. With interest, the amount owed was $152 million at the time of the debt restructuring action. More than $133 million, or 88 percent, has now been written-down or written-off.

TYPES OF LOANS

You expressed interest in the types of loans involved in the restructuring actions. All 74 of the borrowers received one or more emergency loans. A total of 471 actual loss, major adjustment, and/or subsequent operating emergency loans were made to this group. Emergency loans consisted of $133 million of the total, or 88 percent of the debt at the time of the servicing action, and $117 million, also 88 percent of the program losses in the sample.

Senator CONRAD. Let's just emphasize that point. Concerning the losses, 88 percent were as a result of these emergency programs, that have now been eliminated or sharply curtailed by Congress. That really is a very clear message that this is where a significant part of our problem was coming from.

Mr. EBBITT. That's correct, Mr. Chairman.

In addition to those mainline, if I can use that word, emergency loan programs, 27 of the borrowers received 41 Economic Emergency loans that accounted for an additional $11.3 million of the outstanding debt and $10.7 million of the write-downs or write-offs. Taken together, these two emergency loan types amounted to 95 percent of all unpaid debt, and 96 percent of the program losses. So those two Emergency Loan Program categories comprised roughly 96 percent of the written-off or written-down amount.

Senator CONRAD. Ninety-six percent in just those two categories. One of those programs was completely ended back in the 1980's and the other one sharply curtailed. So for the future, we would not expect to have this same kind of problem recur; am I right?

Mr. EBBITT. That's correct.

Senator CONRAD. Well, that's good news.

EMERGENCY LOAN PORTFOLIO

Mr. EBBITT. We also found that 71 borrowers, who had received 291 loans totaling about $100 million prior to 1983, would not have qualified for these loans today for the reasons we have been discussing. For example, emergency loans for major adjustment and subsequent operating purposes are no longer funded. The impact of the major adjustment provision, particularly, had significant impact on the FmHA loan portfolio because borrowers could obtain unlimited funds without regard to the extent of the production loss that was actually incurred. Currently, only actual loss loans are made under emergency loans, and they are capped at $500,000. In addition, current criteria require a 30 percent actual loss to qualify for emergency assistance whereas prior requirements for minimum production losses were substantially less. The total dollar value of losses that would not have been incurred under today's criteria is about $96 million, or 72 percent of the total written off or written down for these borrowers.

Senator CONRAD. So under current law, almost three-quarters of the problem we would not anticipate to happen again because of prior actions taken.

Mr. EBBITT. That's correct, Mr. Chairman.

Senator CONRAD. So in many ways, we are cleaning up the dirty laundry from the past. Because of prior actions, we wouldn't expect those problems to recur.

Mr. EBBITT. That's correct.

Senator CONRAD. That's more good news.

ISSUE OF THE FAMILY-SIZE FARM ELIGIBILITY REQUIREMENT

Mr. EBBITT. Another issue you had expressed interest in dealt with the family-size farm eligibility requirement. Due to the vagueness of the criteria in effect, this is an extremely difficult area to assess, especially through case file review. Nonetheless, looking at that existing criteria, FmHA county office officials concluded that 10 of the 74 borrowers would be considered too large today to qualify for FmHA loans.

Another area difficult to assess was the ability of borrowers to obtain credit elsewhere at the time the loan was made. Of the 74 borrowers in the sample, we found that 25 clearly could not obtain credit elsewhere. We further note where 45 cases there was inadequate or no documentation in the case file that showed that the credit elsewhere test was performed at the time of the loan application, and 4 borrowers who in our view appeared to have the capability to obtain credit elsewhere but were funded by the agency nonetheless.

An example we noted in this category was an individual who had received an FmHA loan in 1979, despite net worth of about $1.9

million. Included in the borrower's net worth were assets not essential to the farming operation, like stocks and bonds of over $325,000; commercial property of $360,000; and two city lots and a store valued at about $76,000.

Senator CONRAD. Did Sox Johnson make that loan? [Laughter.]

Mr. EBBITT. I'm not sure of the date of this loan, Mr. Chairman.

Mr. JOHNSON. No, sir; I don't make loans.

Senator CONRAD. I thought maybe on a high-level one like that. [Laughter.]

THE ISSUE OF THE IMPACT OF LAND VALUE DEPRECIATION

Mr. EBBITT. The last issue you had asked us to review was the impact of land value depreciation in the counties involved in our sample from 1981 to 1987. USDA's Economic Research Service provided us with statistically valid information pertaining to the years 1982 and 1987, taken as part of the "Census of Agriculture." The land values in the 74 counties where the loans had been made ranged from a decrease of 52 percent in West Carroll County, Louisiana, to an increase of 38 percent in Hendry County, Florida. As you would presume, however, the trend was largely negative with 67 counties suffering depreciated values and only 7 counties having appreciated land values. The overall loss in land value was about 24.6 percent. Applying this percentage to the total loss incurred in the restructuring of the 74 borrowers of $133 million in the sample, over $100 million in losses were incurred that cannot be directly attributable to the land value depreciation.

SUMMARY

In summary, Mr. Chairman, our review disclosed that many of the legislative provisions that have been passed over the last few years have served to lessen FmHA's susceptibility to dollar losses of the magnitude now being restructured. As other witnesses have testified here this morning, however, Mr. Chairman, there are some problems in normal servicing actions that we have reported to the agency before that the agency continues to need to work on to prevent future losses from occurring.

Thank you, Mr. Chairman. We can answer any questions you may have.

[The prepared statement of Mr. Ebbitt follows:]

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

STATEMENT OF JAMES R. EBBITT
ASSISTANT INSPECTOR GENERAL FOR AUDIT
OFFICE OF INSPECTOR GENERAL
U.S. DEPARTMENT OF AGRICULTURE

ON THE
IMPLEMENTATION OF THE AGRICULTURAL
CREDIT ACT OF 1987

MARCH 5, 1990

US DEPARTMENT OF AGRICULTURE
OIG
OFFICE OF INSPECTOR GENERAL

THANK YOU MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE. I AM JAMES R. EBBITT, THE ASSISTANT INSPECTOR GENERAL FOR AUDIT, AND WITH ME THIS MORNING IS RICHARD DAVIS, WHO IS THE DIVISION DIRECTOR OF OUR RURAL DEVELOPMENT AND NATURAL RESOURCES DIVISION. WE ARE PLEASED TO APPEAR BEFORE YOU TODAY TO DISCUSS OUR AUDIT WORK OF THE IMPLEMENTATION OF CERTAIN ASPECTS OF THE AGRICULTURAL CREDIT ACT OF 1987, SPECIFICALLY, THE DEBT RESTRUCTURING PROGRAM.

DUE TO THE LARGE DOLLAR MAGNITUDE OF THE PROGRAM, WITH LOSSES ESTIMATED BY FMHA AT ABOUT $10 BILLION, AND ITS INHERENT VULNERABILITY TO ADDITIONAL LOSSES, OIG UNDERTOOK A PREVENTIVE AUDIT APPROACH. FIRST, WE PERFORMED AN INDEPENDENT EVALUATION OF THE DEBT RESTRUCTURING REGULATIONS AS SOON AS THEY WERE AVAILABLE IN DRAFT FORM. THE RESULTS OF OUR REVIEW WERE THEN PROVIDED TO FARMERS HOME ADMINISTRATION OFFICIALS FOR THEIR CONSIDERATION IN FINALIZING THE PROGRAM REQUIREMENTS. AMONG THE ISSUES WE DISCLOSED WAS THE TAX RAMIFICATIONS OF A DEBT WRITE-DOWN OR WRITE-OFF AND THE IMPACT ON THE BORROWERS' CAPABILITY TO SUSTAIN OPERATIONS IN LIGHT OF POTENTIALLY SIGNIFICANT TAX LIABILITIES.

WE INITIATED OUR AUDIT TESTING DURING THE NOVEMBER 1988 PERIOD WHEN FMHA CONDUCTED WHAT WAS REFERRED TO AS ITS "FIRST MAILING," WHEREIN ABOUT 66,500 NOTICES WERE SENT TO BORROWERS WHO WERE 180 DAYS OR MORE DELINQUENT ON ONE OR MORE FARMER PROGRAM LOANS. THE FIRST AREA WE ASSESSED WAS THE SOFTWARE PROGRAM DEVELOPED BY FMHA TO PERFORM DEBT RESTRUCTURING COMPUTATIONS AND FACILITATE THE SERVICING ACTIONS. OUR REVIEW DISCLOSED THAT THE PROGRAM, ENTITLED THE DEBT AND LOAN RESTRUCTURING SYSTEM, OR DALR$, HAD NOT BEEN THOROUGHLY NOR INDEPENDENTLY TESTED TO ENSURE THE ACCURACY AND RELIABILITY OF THE SOFTWARE. WE REPORTED THIS MATTER TO FMHA; IN RESPONSE, THE AGENCY

CONTRACTED WITH A NATIONAL CPA FIRM TO TEST THE SYSTEM. THE CONTRACTOR DETERMINED THAT THERE WAS REASONABLE ASSURANCE THAT THE PROGRAM WAS RELIABLE, HOWEVER, IDENTIFIED POTENTIAL PROCESSING PROBLEMS AND PROPOSED ENHANCEMENTS TO IMPROVE THE OPERATING EFFICIENCY OF THE PROGRAM.

FMHA HAS PREVIOUSLY ENCOUNTERED PROBLEMS IN NOTIFYING BORROWERS OF PROGRAM PROVISIONS. FOR EXAMPLE, SERVICING OPTIONS AVAILABLE TO DELINQUENT BORROWERS WERE NOT ADEQUATELY CONVEYED TO BORROWERS WHICH RESULTED IN THE COLEMAN/BLOCK LITIGATION. AS A RESULT, WE THEN EVALUATED THE DEBT RESTRUCTURING PROGRAM NOTIFICATION PROCESS. THIS REVIEW WAS CONDUCTED AT VARIOUS FMHA OFFICES NATIONWIDE AND SURFACED ONLY MINOR INDIVIDUAL ERRORS, NOT SYSTEMIC OR WIDESPREAD DEFICIENCIES.

AS THE FIRST DEBT RESTRUCTURING APPLICATIONS WERE BEING PROCESSED, WE PERFORMED AN ANALYSIS AT 5 STATE AND COUNTY OFFICES OF FMHA's METHODOLOGY IN ORDER TO IDENTIFY POTENTIAL WEAKNESSES WHICH COULD ADVERSELY IMPACT ON THE PROGRAM IMPLEMENTATION AS A WHOLE. DURING THIS PHASE OF OUR AUDIT WE ISSUED A TOTAL OF EIGHT REPORTS WHICH DISCLOSED ISSUES THAT WARRANTED PROMPT ACTION BY MANAGEMENT. AMONG THE FINDINGS WE IDENTIFIED WAS THAT CURRENT FINANCIAL STATEMENTS HAD NOT BEEN OBTAINED FROM INDIVIDUALS AND ENTITIES WHO HAD SIGNED THE ORIGINAL PROMISSORY NOTES. FOR EXAMPLE, WE FOUND ONE CASE WHERE A LIMITED PARTNERSHIP HAD DELINQUENT DEBT DUE TO FMHA OF $22 MILLION. THE GENERAL PARTNER'S PERSONAL ASSETS INCLUDED INTERESTS IN A HYDROELECTRIC PROJECT, AN EXCLUSIVE RESIDENTIAL HOUSING DEVELOPMENT, AND POSSIBLY A HOTEL AND GOLF COURSE. ACCORDINGLY, THE GENERAL PARTNER'S PERSONAL ASSETS MAY HAVE BEEN SUFFICIENT TO SATISFY SOME OR ALL OF THE PARTNERSHIP DEBT, YET FMHA HAD NOT ENSURED THEY WOULD BE CONSIDERED PRIOR TO A DEBT RESTRUCTURING OFFER. IN

ADDITION, WE NOTED A HIGH ERROR RATE AT THE COUNTY OFFICE LEVEL IN ENTERING DATA INTO DALR$, RESULTING IN INCORRECT DEBT RESTRUCTURING DECISIONS. FURTHER, WE REPORTED ON THE NEED FOR FMHA TO STRENGTHEN EXISTING PROCEDURES TO ENSURE THAT BORROWERS' FARM AND HOME PLANS WERE CONSISTENTLY REVIEWED AND ADEQUATELY SUPPORTED. ANOTHER ISSUE WE SURFACED DEALT, AGAIN, WITH THE IMPACT OF TAX LIABILITIES IN BORROWERS' ESTIMATES OF FUTURE FINANCIAL POSITION. DUE TO THE COMPLEXITY OF THE TAX ASPECTS, FMHA HAS BEEN RELUCTANT TO ASSUME THE ROLE OF TAX COUNSELORS OR EXPERTS. NONETHELESS, WE NOTED AN EXAMPLE WHEREIN A BORROWER ESTIMATED THE TAX LIABILITY TO BE BASED UPON THE ENTIRE AMOUNT OF THE DEBT DUE TO BE WRITTEN DOWN, OR $200,000. THE WRITE-DOWN OFFER, HOWEVER, COMPUTED WITH NO TAX LIABILITY ESTIMATED, WAS FOR ONLY $33,000. WHEN DALR$ WAS RERUN USING THE BORROWER'S TAX ESTIMATE, HE WAS NO LONGER PROJECTED TO BE ABLE TO CASH FLOW, AND THUS WAS OFFERED A NET RECOVERY BUYOUT OF $7,100 INSTEAD. AS A RESULT, THE LOSS WAS $160,000 GREATER THAN WHAT SHOULD HAVE BEEN INCURRED. WE RECOMMENDED, AND THE AGENCY AGREED, THAT MINIMUM REASONABLENESS TESTS BE PERFORMED TO PRECLUDE COMPUTING RESTRUCTURING DECISIONS BASED UPON INFLATED TAX ESTIMATES.

ONE OF OUR MORE SIGNIFICANT FINDINGS THUS FAR, HOWEVER, HAS BEEN OUR DISCLOSURE OF THE LOOPHOLE IN THE ACT WHICH PERMITTED BORROWERS WHO HAD NOT ACTED IN GOOD FAITH TO PARTICIPATE, WITHOUT RECOURSE, IN THE NET RECOVERY BUYOUT OPTION. BORROWERS WHO HAD ILLEGALLY DISPOSED OF SECURITY PROPERTY WERE, IN ESSENCE, NOT ONLY ABLE TO OBTAIN IMMUNITY FROM PROSECUTION BUT TO DIRECTLY GAIN MONETARY BENEFITS FROM THE PERPETRATION OF THE FRAUD. FMHA HAS COMPILED STATISTICS THAT SHOWED OVER 280 BORROWERS WITH WRITE-OFFS TOTALING NEARLY $70 MILLION HAD WRONGFULLY TAKEN ADVANTAGE OF THIS DISCREPANCY. WE RECOMMENDED THAT LEGISLATION BE SOUGHT TO RECTIFY THIS CONDITION AND THAT

MEASURES BE PURSUED TO ADD-BACK THE VALUE OF ANY IMPROPERLY DISPOSED PROPERTY. WE UNDERSTAND THAT LEGISLATION HAS BEEN INTRODUCED BY YOU, MR. CHAIRMAN, AND IN THE HOUSE TO CLOSE THIS LOOPHOLE. WE STRONGLY ENDORSE PROMPT PASSAGE OF LEGISLATION CONTAINING THIS PROVISION.

WE'D LIKE TO NOTE THAT FMHA HAS BEEN VERY RESPONSIVE IN DEVELOPING AND IMPLEMENTING CORRECTIVE ACTIONS FOR ALL ISSUES WE HAVE REPORTED.

IN JANUARY OF THIS YEAR WE EMBARKED UPON A NATIONWIDE REVIEW OF THE PROPRIETY OF THE WRITE-DOWN AND WRITE-OFF ACTIONS. THIS WORK IS BEING PERFORMED IN 11 STATES AND IS EMPHASIZING LARGE DOLLAR TRANSACTIONS. IN ADDITION, WE ARE REVIEWING SEVERAL CASES, AT YOUR REQUEST MR. CHAIRMAN, IN WHICH THE BORROWERS DID NOT QUALIFY FOR DEBT RESTRUCTURING AND DID NOT HAVE THE FINANCIAL RESOURCES FOR THE NET RECOVERY BUYOUT. WE HAVE DEVELOPED SEVERAL PRELIMINARY ISSUES THUS FAR BUT HAVE NOT YET PROGRESSED TO THE POINT THAT WE HAVE DISCUSSED THEM WITH THE AGENCY. WE CAN SHARE ONE EXAMPLE WITH YOU, HOWEVER, THAT WE IDENTIFIED WHICH FULLY DEPICTS THE POTENTIAL VULNERABILITY TO LOSSES IN EXCESS OF WHAT THE LEGISLATION ENVISIONED. ALTHOUGH THE AGENCY HAS NOT YET RESPONDED TO THE ISSUES, WE NOTED THAT FINANCIAL DATA REPORTED BY THE BORROWER CONTAINED MAJOR INACCURACIES AND OMISSIONS THAT THE STATE AND COUNTY OFFICES FAILED TO DETECT. THESE ERRORS INCLUDED THE EXCLUSION OF ASSETS AND INCOME IN EXCESS OF $2.9 MILLION AND THE EXCLUSION OF LIABILITIES IN EXCESS OF $1.9 MILLION ON THE BORROWER'S APPLICATION. THE NET RESULT OF OUR REVIEW DISCLOSED THAT THE WRITE-DOWN OFFERED TO THE BORROWER WAS OVERSTATED BY $984,163.

AS OUR WORK CONTINUES, WE ARE ALSO CONCENTRATING ON IDENTIFYING POSSIBLE SCHEMES AND DEVICES USED BY BORROWERS THAT MAY HAVE RESULTED IN ADDITIONAL

LOSSES TO THE GOVERNMENT. OFFERS FOR DEBT WRITE-DOWN AND NET RECOVERY BUYOUT ARE BASED UPON COMPLEX ANALYSES WHICH RELY HEAVILY UPON THE ACCURACY AND RELIABILITY OF INFORMATION FURNISHED BY BORROWERS. OUR AUDIT WILL CONTINUE TO FOCUS ON THOSE BORROWERS WHO HAVE RECEIVED WRITE-DOWNS OR WRITE-OFFS OF $1 MILLION OR MORE. THIS IS A LOAN POPULATION OF SIGNIFICANT SIZE; ALTHOUGH 93 BORROWERS IN THIS CATEGORY HAD BEEN PROCESSED AS OF SEPTEMBER 30, 1989, ANOTHER GROUP OF OVER 600 OWE FMHA $1 MILLION OR MORE AND ARE CURRENTLY DELINQUENT. THE AGGREGATE DEBT OF THESE BORROWERS IS $1.3 BILLION.

ON NOVEMBER 1, 1989, MR. CHAIRMAN, YOU REQUESTED US TO ANALYZE THE LOAN HISTORIES OF THOSE BORROWERS WHO HAD RECEIVED WRITE-DOWNS OR WRITE-OFFS OF $1 MILLION OR MORE. TO ACCOMPLISH THIS TASK, WE USED THE SEPTEMBER 30, 1989 UNIVERSE OF 93 BORROWERS. IN ORDER TO PERFORM SUCH A DETAILED EXAMINATION IN AN ABBREVIATED TIMEFRAME, WE DEVELOPED AN EXTENSIVE QUESTIONNAIRE TO BE PREPARED BY THE COUNTY OFFICES WHERE THE LOANS HAD BEEN MADE. FMHA NOTED THAT THE TIME NECESSARY TO COMPLETE OUR QUESTIONNAIRE IN A PERIOD OF HEAVY WORKLOAD WOULD UNDULY BURDEN THEIR STAFF. ACCORDINGLY, WE AGREED TO LIMIT THE WORK TO NO MORE THAN ONE BORROWER PER COUNTY OFFICE. THIS RESULTED IN DECREASING THE STUDY UNIVERSE TO 74. WE WILL BE PROVIDING YOU WITH A FORMAL REPORT ON THE RESULTS OF THIS REVIEW SOON.

I AM PREPARED AT THIS TIME TO PROVIDE A SUMMARY OF OUR RESPONSES TO YOUR QUESTIONS. THE 74 BORROWERS IN OUR SAMPLE HAD RECEIVED A TOTAL OF 639 LOANS WITH ORIGINAL LOAN AMOUNTS OF OVER $119 MILLION. DUE TO ACCRUING INTEREST IN THE PERIODS OF DELINQUENCY, THIS SUM INCREASED TO OVER $152 MILLION AT THE TIME OF THE DEBT RESTRUCTURING ACTION. MORE THAN $133 MILLION, OR 88 PERCENT, WAS WRITTEN-DOWN OR WRITTEN-OFF.

YOU EXPRESSED INTEREST IN THE TYPES OF LOANS INVOLVED IN THE RESTRUCTURING. ALL 74 BORROWERS RECEIVED ONE OR MORE EMERGENCY LOANS. A TOTAL OF 471 ACTUAL LOSS, MAJOR ADJUSTMENT, AND/OR SUBSEQUENT OPERATING EMERGENCY LOANS WERE MADE TO THIS GROUP. EMERGENCY LOANS CONSISTED OF $133 MILLION, OR 88 PERCENT OF THE DEBT AT THE TIME OF THE SERVICING ACTION AND $117 MILLION, ALSO 88 PERCENT, OF THE PROGRAM LOSSES IN THE SAMPLE. IN ADDITION, 27 BORROWERS RECEIVED 41 ECONOMIC EMERGENCY LOANS THAT ACCOUNTED FOR $11.3 MILLION OF THE OUTSTANDING DEBT AND $10.7 MILLION OF THE WRITE-DOWNS OR WRITE-OFFS. TAKEN TOGETHER, THESE TWO EMERGENCY LOAN TYPES AMOUNTED TO 95 PERCENT OF ALL UNPAID DEBT AND 96 PERCENT OF THE PROGRAM LOSSES. THE MOST SIGNIFICANT PROGRAM ACTIVITY OTHER THAN EMERGENCY-TYPE LOANS CONSISTED OF FARM OPERATING AND FARM OWNERSHIP LOANS; 42 BORROWERS HAD 64 SUCH LOANS THAT HAD DELINQUENCIES OF $5.5 MILLION AND LOSSES OF $4.1 MILLION.

EXAMINING FURTHER THE IMPACT OF THE EMERGENCY LOAN PORTFOLIO, YOU HAD INQUIRED AS TO WHETHER FARMERS WOULD QUALIFY FOR THE SAME LOAN ASSISTANCE UNDER CURRENT LAW COMPARED WITH THE ELIGIBILITY CRITERIA IN EFFECT PRIOR TO 1983. WE FOUND THAT 71 BORROWERS, WHO HAD 291 LOANS TOTALING ABOUT $100 MILLION, WOULD NOT HAVE QUALIFIED TODAY. THE REASONS FOR THESE DENIALS WOULD BE VARIED. FOR EXAMPLE, EMERGENCY LOANS FOR MAJOR ADJUSTMENT AND SUBSEQUENT OPERATING PURPOSES ARE NO LONGER FUNDED. THE IMPACT OF THE MAJOR ADJUSTMENT PROVISION, PARTICULARLY, HAD SIGNIFICANT IMPACT ON THE FMHA LOAN PORTFOLIO BECAUSE BORROWERS COULD OBTAIN UNLIMITED FUNDS WITHOUT REGARD TO THE EXTENT OF THE PRODUCTION LOSS INCURRED. CURRENTLY, ONLY ACTUAL LOSS LOANS ARE MADE, AND CAPPED AT $500,000. IN ADDITION, CURRENT CRITERIA REQUIRES A 30 PERCENT ACTUAL LOSS TO QUALIFY FOR EMERGENCY ASSISTANCE WHEREAS PRIOR REQUIREMENTS FOR MINIMUM PRODUCTION LOSSES WERE SUBSTANTIALLY LESS. THE TOTAL DOLLAR VALUE OF

LOSSES THAT WOULD NOT HAVE BEEN INCURRED UNDER TODAY'S CRITERIA IS ABOUT $96 MILLION, OR 72 PERCENT OF THE TOTAL.

ANOTHER HISTORICAL EMERGENCY LOAN PROVISION THAT IMPACTED THE DELINQUENCY TOTALS WAS THE 1975 LAW THAT PERMITTED UP TO FIVE SUBSEQUENT ANNUAL EMERGENCY PRODUCTION LOANS WITHOUT EXPERIENCING ANOTHER DISASTER OR LOSS. OUR REVIEW OF THE 74 BORROWERS DISCLOSED THAT 54 HAD RECEIVED 152 LOANS, OR 80 PERCENT OF THE OPERATING-TYPE LOANS MADE UNDER THE EMERGENCY DESIGNATION, UNDER THIS ELIGIBILITY CRITERION. THE DOLLAR VALUE OF THESE LOANS WAS ABOUT $53 MILLION WITH ASSOCIATED LOSSES OF ABOUT $50.9 MILLION. PLEASE NOTE THAT THESE FIGURES ARE INCLUDED IN THE PREVIOUSLY DISCUSSED TOTALS.

TO A LESSER EXTENT, THE SO-CALLED CONTINUATION POLICY, WHEREIN THE BORROWER IS REQUIRED TO SHOW REPAYMENT ABILITY ON ONLY THE AMOUNT APPLIED FOR AND NOT THE ENTIRE INDEBTEDNESS, HAS CONTRIBUTED TO PROGRAM LOSSES. WE FOUND THAT 31 OF THE 74 BORROWERS WE REVIEWED HAD RECEIVED 59 LOANS THAT TOTALED ABOUT $15 MILLION UNDER THIS PROVISION.

ANOTHER ISSUE YOU HAD EXPRESSED INTEREST IN DEALT WITH THE FAMILY SIZE FARM ELIGIBILITY REQUIREMENT. DUE TO THE VAGUENESS OF THE CRITERIA IN EFFECT, THIS IS AN EXTREMELY DIFFICULT AREA TO ASSESS AT ANY TIME, BUT ESPECIALLY AFTER-THE-FACT THROUGH REVIEWS OF CASE FILES. NONETHELESS, EVEN WITH VAGUE CRITERIA THE FMHA COUNTY OFFICIALS CONCLUDED THAT 10 OF THE 74 BORROWERS WOULD BE CONSIDERED TOO LARGE TODAY TO QUALIFY. FOR EXAMPLE, ONE BORROWER AT THE TIME OF HIS INITIAL LOAN APPLICATION IN 1977, OWNED 1,500 ACRES VALUED AT $1.5 MILLION AND HAD A NET WORTH OF OVER $1 MILLION. THE FARM OPERATION WAS PRIMARILY A LIVESTOCK AND DAIRY OPERATION. THE BORROWER RETAINED FIVE FULL

TIME EMPLOYEES AND HAD ANNUAL LABOR EXPENSES OF $80,000. ANNUAL OPERATING FUND NEEDS WERE OVER $400,000. ALTHOUGH THE FAMILY SIZE FARM DEFINITION DOES NOT INCLUDE REFERENCES TO ACREAGE, NET WORTH, OR LEVELS OF PRODUCTION EXPENSES, IT DOES STATE THAT THE BORROWER PROVIDE A SUBSTANTIAL AMOUNT OF THE LABOR REQUIREMENTS. IN THIS CASE, THAT WAS NOT APPARENT.

ANOTHER AREA DIFFICULT TO ASSESS WAS THE ABILITY OF BORROWERS TO OBTAIN CREDIT ELSEWHERE AT THE TIME THE LOAN WAS MADE. OF THE 74 BORROWERS IN THE SAMPLE, WE FOUND THAT 25 CLEARLY COULD NOT OBTAIN CREDIT ELSEWHERE. WE FURTHER NOTED THAT IN 18 CASES THERE WAS NO DOCUMENTATION IN THE CASE FILE THAT SHOWED THAT THE CREDIT ELSEWHERE TEST WAS PERFORMED AT THE TIME OF THE LOAN APPLICATION. IN 27 OTHER CASES THERE WAS SOME DOCUMENTATION AVAILABLE THAT INDICATED CREDIT ELSEWHERE WAS CONSIDERED, BUT THAT DOCUMENTATION WAS FREQUENTLY MINIMAL, CONSISTING OF LIMITED NOTATIONS, FOR EXAMPLE, THAT WOULD NOT MEET CURRENT REQUIREMENTS. THE REMAINING FOUR BORROWERS, IN OUR VIEW, APPEARED TO HAVE THE CAPABILITY TO OBTAIN CREDIT ELSEWHERE BUT WERE FUNDED BY THE AGENCY NONETHELESS. AN EXAMPLE WE NOTED IN THIS CATEGORY WAS AN INDIVIDUAL WHO RECEIVED AN FMHA LOAN IN 1979 DESPITE NET WORTH OF $1.9 MILLION. INCLUDED IN THE BORROWER'S NET WORTH WERE ASSETS NOT ESSENTIAL TO THE FARMING OPERATION, LIKE STOCKS AND BONDS OF OVER $325,000; COMMERCIAL PROPERTY OF $360,000; AND TWO CITY LOTS AND A STORE VALUED AT $76,000. THE INDIVIDUAL'S PROPERTY CONSISTED OF A 269 ACRE FARM AND A RESIDENCE THAT QUALIFIES UNDER MOST RULES OF REASON AS A MANSION: 5,700 SQUARE FEET OF LIVING SPACE, HEATED SWIMMING POOL, AND 2 LIGHTED TENNIS COURTS. THE COUNTY OFFICE HAD NOT REQUIRED THE NONESSENTIAL ASSETS TO BE LIQUIDATED AS A PREREQUISITE TO LOAN QUALIFICATION, HAD NOT OBTAINED ALL ASSETS AS LOAN SECURITY, AND HAD MADE ONLY CURSORY AND BELATED CONTACTS WITH OTHER POTENTIAL LENDERS.

REGARDING YOUR QUESTION AS TO HOW MANY BORROWERS WOULD HAVE QUALIFIED FOR FMHA ASSISTANCE IF THE ABILITY TO REPAY ALL DEBTS HAD BEEN IN EXISTENCE AT THE TIME THE LOANS WERE MADE, WE FOUND THAT 35 BORROWERS, RECEIVING 88 LOANS FOR OVER $21.7 MILLION, DID NOT EXHIBIT THE CAPABILITY TO REPAY ALL DEBTS. THESE STATISTICS DO NOT INCLUDE OPERATING LOANS SINCE THE CONTINUATION POLICY REMAINS IN EFFECT.

THE LAST ISSUE YOU HAD ASKED US TO REVIEW WAS THE IMPACT OF LAND VALUE DEPRECIATION IN THE COUNTIES INVOLVED IN OUR SAMPLE FROM 1981 TO 1987. USDA's ECONOMIC RESEARCH SERVICE PROVIDED US WITH STATISTICALLY VALID INFORMATION PERTAINING TO THE YEARS 1982 AND 1987, TAKEN AS PART OF THE "CENSUS OF AGRICULTURE." WE REQUESTED ADDITIONAL DATA SPECIFICALLY DEALING WITH 1981 AND WERE PROVIDED WITH LAND VALUE INFORMATION COMPILED FROM AN ASCS OPINION POLL OF ROUGHLY 3,000 COUNTY EXECUTIVE DIRECTORS. ERS CAUTIONED US ABOUT RELYING ON THE VALIDITY OF THE 1981 DATA. OUR COMPARISON OF THE 1981 TO 1982 INFORMATION DISCLOSED SUCH WIDE-RANGING VARIATIONS THAT WE DECIDED TO PROVIDE YOU WITH ONLY THE 1982 TO 1987 COMPARATIVE ANALYSIS. THE LAND VALUES IN THE 74 COUNTIES WHERE THE LOANS HAD BEEN MADE RANGED FROM A DECREASE OF 52 PERCENT IN WEST CARROLL, LOUISIANA, TO AN INCREASE OF 38 PERCENT IN HENDRY, FLORIDA. AS YOU WOULD PRESUME, HOWEVER, THE TREND WAS LARGELY NEGATIVE WITH 67 COUNTIES SUFFERING DEPRECIATED VALUES AND ONLY SEVEN COUNTIES HAVING APPRECIATED. THE OVERALL LOSS WAS 24.6 PERCENT. APPLYING THIS PERCENTAGE TO THE TOTAL LOSS INCURRED IN RESTRUCTURING THE 74 BORROWERS OF $133.3 MILLION IN THE SAMPLE, OVER $100 MILLION IN LOSSES WERE INCURRED THAT CANNOT BE DIRECTLY ATTRIBUTABLE TO LAND VALUE DEPRECIATION.

IN SUMMARY, OUR REVIEW DISCLOSED THAT MANY OF THE LEGISLATIVE PROVISIONS THAT HAVE BEEN PASSED OVER THE LAST FEW YEARS HAVE SERVED TO LESSEN FMHA'S SUSCEPTIBILITY TO DOLLAR LOSSES OF THE MAGNITUDE NOW BEING INCURRED. HOWEVER, IN OUR OPINION, FMHA'S RISK OF PROGRAM LOSSES REMAINS HIGH DUE TO CONTINUING SYSTEMIC WEAKNESSES IN LOAN MAKING AND LOAN SERVICING. THIS CONCLUDES MY STATEMENT, MR. CHAIRMAN.

Senator CONRAD. Thank you, Mr. Ebbitt.

We very much appreciate the assistance that you have provided to this committee and to the agency as well. I think the agency feels that way, and we certainly do. It has been very helpful, and I think you have done extremely good work and are to be commended for it.

Let me ask you about the last statement you made that there were some administrative actions of the agency that need to be dealt with. Could you identify what those issues are and what steps are being taken to address those from your perspective?

Mr. EBBITT. Mr. Chairman, the actions I am referring to are mainly in the loan processing and loan servicing. It is not directly related to the 1987 act and debt restructuring. I am talking about across-the-line loan administration by the agency.

Senator CONRAD. It is obviously a very difficult thing. I don't think anybody should underestimate the administrative difficulty of getting every county office to implement the law consistently. That is a major hurdle. Is that what you are addressing here?

Mr. EBBITT. That is very true. I am also addressing just the handling of applications across-the-board when they come in for any loan program. The programs are complex. The administration at the county office level, frequently is such that they don't have all the staff that is necessary to operate the program in the optimum. You put all that together, and frequently a County Supervisor will be rushed in coming to the final decision. As a result of that, farm visits, for example, to stay on top and to help farmers progress, sometimes that suffers. You can't put that in priority when you have a whole desk full of debt restructuring actions to deal with. Working with the Farm and Home Plan is a difficult document to put together for the County Supervisor and frequently for the farmer as well.

So it is those kinds of issues where we have reported to the agency and have also made recommendations that they attempt to tighten up in those particular areas.

Senator CONRAD. And can you tell us the response of the agency to your specific suggestions?

Mr. EBBITT. The agency has been very responsive. In fact, whenever we have brought these recommendations to their attention, they have held meetings around the county, they have put out administrative announcements. One of the best things they have probably done as it relates to debt restructuring was to develop a checklist that their County Supervisors could follow to make sure that they had filled in all the blocks, that they had considered all the elements as the restructuring application was being considered. I think that has done a lot to tighten up that particular aspect.

Senator CONRAD. Are there any administrative shortcomings that you have identified that they have not responded affirmatively to that this committee should be aware of?

Mr. EBBITT. None that come to mind, Mr. Chairman. I can't think of any at all.

Senator CONRAD. Well, that, too, is good news.

Thank you, Mr. Ebbitt, for your testimony.

Mr. EBBITT. Thank you, Mr. Chairman.

Senator **Conrad**. Next we will hear from John Harman, Director, Food and Agriculture Issues, Resources, Community, and Economic Development Division of the General Accounting Office.

Again, Mr. Harman, you have had a number of opportunities to testify and have been of enormous help to this committee as we consider the problems in farm credit. I want to thank you for your past contributions and again welcome you here today.

STATEMENT OF JOHN W. HARMAN, DIRECTOR, FOOD AND AGRICULTURE ISSUES, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC; ACCOMPANIED BY JOHN HUNT, ASSISTANT DIRECTOR, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON DC; JESSE FLOWERS, GAO EVALUATOR, ATLANTA REGIONAL OFFICE; AND JOHN WANSKA, GAO EVALUATOR, CHICAGO REGIONAL OFFICE

Mr. **Harman**. Thank you, Mr. Chairman. We appreciate your kind words and do appreciate the opportunity to be here on several occasions to talk about the problems of Farmers Home.

INTRODUCTION

Today we will discuss the preliminary results of our work on the Farmers Home Administration's implementation of the debt servicing provisions of the Agricultural Credit Act. That work we have been doing at the request of Chairman Leahy of the full committee, we will also discuss the preliminary results of work we just started in January on the sales of farm inventory properties that is being done for you.

Before I begin, I'd like to introduce John Hunt, who is no stranger to this table either over the last month or so. John is responsible for our work overall in the farm credit area.

Senator **Conrad**. Welcome back, John. We appreciate the really excellent work you have done and the contribution you have made to our trying to address these problems. It has been of significant help.

Mr. **Hunt**. Thank you, Mr. Chairman.

CHARTS

Mr. **Harman**. The presentation that we'll be giving this morning will be somewhat different than the previous testimonies we have given on Farmers Home in that we'll be relying very heavily on charts, and I will be asking staff who has been responsible for doing that work to walk you through those charts.

WE REVIEWED THE DEBT SERVICING ACTIONS OF 10 FARMERS HOME COUNTY OFFICES IN 10 STATES

Regarding the implementation of the act, we reviewed the debt servicing actions of 10 Farmers Home county offices in 10 States that had the largest number of debt servicing notification packages sent to delinquent borrowers in November 1988. Each county had a high number of delinquent borrowers. The results, however, are not projectable either to the State level or to the national level.

At this point, I'd like to introduce Jesse Flowers, who has been the evaluator in charge of the work that we have been doing on this assignment; he will provide you the details.

The charts we will be using, by the way, are attached in appendix I of my prepared statement, which has been submitted to the subcommittee for the record, and as I know is your practice—I don't think I have to say this—but I will encourage you to ask questions as we go through the charts.[12]

Mr. **Flowers**. Good morning, Mr. Chairman.

Senator **Conrad**. Good morning and welcome.

Mr. **Flowers**. Thank you, Senator.

As John mentioned, our charts are in the package that we have handed you, so I will try to highlight the charts, and as you have questions, we can get into the details.

CHART 1—ELIGIBLE BORROWERS WHO APPLIED FOR DEBT RELIEF

The first chart shows the number of borrowers who were eligible in terms of 180 days delinquent and the number who actually got notification packages and the number who applied. As the chart shows, almost all of the borrowers who were 180 days delinquent did receive an application package, an opportunity to apply. However, less than half of those actually applied; 569 applied, or about 44 percent; 703 borrowers did not apply.

Senator **Conrad**. Can you tell us what is the difference between those eligible and the small number who didn't get packages at all? Was it an inability to identify where they were, or do you know?

Mr. **Flowers**. There was a variety of reasons. Some of the borrowers they could not locate. There was some confusion about whether or not a particular borrowers should receive a packet. Ultimately, although they are not included in our numbers, 14 of the 21 who did not receive a package did ultimately get the package.

Senator **Conrad**. That's pretty darned good.

Let me ask you another question. The borrowers that applied for servicing, 569—and maybe I am jumping ahead of you; if I am, say so—do we know what the fall-off is? Where are those other folks?

Mr. **Flowers**. We will get to that as we go through our charts.

Senator **Conrad**. All right.

CHART 2—REASONS BORROWERS DID NOT APPLY FOR SERVICING

Mr. **Flowers**. On chart 2, looking at the 703 borrowers who did not apply, we wanted to have some idea of why they did not apply. As the chart shows, a large percentage, 44 percent, were considered to be inactive farmers or inactive borrowers at the time. Some other reasons were that the borrowers requested debt settlement or chose to pay their debts in full or pay them current once they received the package.

Senator **Conrad**. So there were 24, "reason unknown" for percent of nonapplying borrowers; number of borrowers with "reason unknown" is 172. So 172 of the 703, we just don't know.

Mr. **Flowers**. We just couldn't determine.

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[12] See pp. 455 to 460 for charts 1-11, appendixes I and II.

Senator **Conrad**. Why is it that we don't know—we are not able to find them?

Mr. **Flowers**. We interviewed 35 of those borrowers that did not apply, and the reasons that they gave us kind of fell across the range that we have on the table. Some of those requested debt settlement, and some repaid debts. Very few of those did not apply because they felt like the application process was too complex or too burdensome for them.

Senator **Conrad**. What's happening to those people? Are they just giving up? How do those people go on?

Mr. **Harman**. Well, I don't think we looked at that to see what is happening. That's a good question. I think that gets into another question about how do we transition people out of Farmers Home into something else, what is our ability to do that, and we really don't have that answer.

Senator **Conrad**. All right.

CHART 3—BORROWERS WHO HAD DEBT SERVICING OFFERED AND COMPLETED AS OF JUNE 30, 1989

Mr. **Flowers**. The next chart shows of the 569 borrowers who applied, FmHA made offers to 474 of those. About 83 percent of those who applied got an offer. Almost two-thirds of the offers were for the net recovery buyout option, and the remaining 35 percent were primary servicing with a write-down or without a write-down.

Senator **Conrad**. These numbers are very interesting, because when we started down this path, most of us anticipated net recovery buyouts would be offered to a fairly small percentage of borrowers, and it is turning out to be a big percentage.

Do we have any way of knowing why that is happening?

Mr. **Flowers**. Most of those that received the net recovery buyout could not project a cash-flow even with the restructuring, even with the write-down.

Mr. **Harman**. They were just in such poor financial condition that their cash-flow criteria, they couldn't meet it until they hit that net recovery value figure, and therefore they'd go into that.

Senator **Conrad**. OK.

CHART 4—REASONS BORROWERS WERE DENIED SERVICING

Mr. **Flowers**. The next chart, we attempted to look at some reasons why some of the borrowers did not get servicing or were denied servicing. The largest single reason was that the borrowers never submitted a complete package. Even though the application period was extended by the good faith rule of reason process, for one reason or another they never got a complete package in.

CHART 5—BORROWERS BY RANGE OF BORROWER DEBT PRIOR TO LOAN SERVICING

In the next chart, we look at the amount of debt owed by the borrowers prior to servicing under the act. Again, we started with the 474 borrowers who received offers. We obtained detailed information on 434 of those. The table shows that about 56 percent of the 434 borrowers had an FmHA debt prior to servicing of less than $250,000. About 19 borrowers owed FmHA more than $1 million prior to servicing.

CHART 6—SERVICED BORROWERS BY TYPE OF LOANS

The next chart shows the type of loan that was held by those borrowers who were serviced under the act. We cut our figures a little bit different than some of the previous folks who have testified. Most of the 434 borrowers that we looked at, about 61 percent of them had a combination of FmHA farm or program loan types. This would include the emergency loans, both the Economic Emergency and the Emergency Natural Disaster loans, and one or more loan types such as Farm Ownership or Farm Operating loans.

About 15 percent of those 434 borrowers had only emergency loans, Economic Emergency or the Natural Disaster Emergency. The remaining 24 percent had no emergency loans.

Mr. HUNT. Mr. Chairman, I think an important point here is in contrast to what Mr. Ebbitt testified about the million-dollar borrowers, these borrowers would cover the full spectrum of all the loan types. With the Farm Operating/Farm Ownership loans, you can never get to $1 million; there would be a maximum limit of $700,000 combined direct and guaranteed, Farm Ownership/Farm Operating.

Senator CONRAD. Let me raise this point. Mr. Ebbitt found in that group that the overwhelming problem was in those emergency loans. Did you find the same thing?

Mr. HARMAN. That is a problem with the loss category. Those are large loans, and a lot of the losses have occurred in that category. Also, when you concentrated on the million dollars or more loans, automatically, you are into those emergency loans. So therefore I think you expect to see a high percentage due to those.

But these people not only got emergency loans, they also got operating loans and ownership loans, but probably operating loans, which also got tied up in the whole process. So that you don't know whether or not the fact they got these huge emergency loans caused them problems in the other loans or whether they got those loans afterwards. We have not done that kind of analysis. But there is no doubt that the emergency loans were a big problem in terms of the losses under this program.

Senator CONRAD. All right.

Sox.

Mr. JOHNSON. If I might ask a question, did you break that out into dollars as well as numbers of those who had combinations of loans?

Mr. HARMAN. No.

Mr. JOHNSON. I would suspect you would find that a large percentage of the dollars related to emergency because again, the Farm Ownership and Operating loans were available only to family size operators. It would be interesting to see the dollars broken out.

Mr. HARMAN. That could very well be.

Senator CONRAD. Those Economic Emergency loans and Emergency Disaster loans were a disaster themselves. I think that is a fair conclusion. Congress came to that conclusion long ago, and thank goodness they shut off that hemorrhage.

Go ahead.

CHART 7—BORROWERS AND AMOUNT OF DEBT; DEBT REDUCTION, BY SERVICING CATEGORY

Mr. **Flowers**. The next chart shows the servicing that was offered to the 434 borrowers. First it shows that FmHA wrote down or wrote off $91 million of debt in the 10 counties. This represented about two-thirds of the total $135 million debt owed by the 434 borrowers.

Second, the chart shows that about 63 percent of the 434 borrowers could not project a cash-flow with debt restructuring——

Senator **Conrad**. Sixty-three percent of the 434 borrowers?

Mr. **Flowers**. Yes, sir, 63 of the 434 borrowers.

Senator **Conrad**. So about one in seven could not project cash-flow. OK.

Mr. **Flowers**. About 18 percent of the borrowers were offered debt restructuring with a write-down totaling about $26 million.

The table also shows that if we look at the number of borrowers who received a write-down and the number who received a net recovery buyout, about 350 of the 434 that we looked at received those kinds of servicing options.

CHART 8—BORROWERS BY RANGE OF WRITE-DOWNS AND WRITE-OFFS

In the next chart, we look at those 350 borrowers and stratify the amount of write-down and write-off. The table shows the range, about 68 percent of the 350 received a write-down or write-off less than $250,000, and 10 borrowers received a write-down or write-off that equaled or exceeded $1 million.

Senator **Conrad**. Just below a half-million, you'd have nearly 90 percent of the write-downs and write-offs. All right.

Mr. **Flowers**. Yes, sir.

Mr. **Harman**. That probably gets back to the question that Sox raised, though, too. The numbers are in those lower categories, but the dollars may very well be in the higher categories. I don't think we've made a cut of that. It would not be hard to do.

Senator **Conrad**. Could you do that?

Mr. **Harman**. Surely.

Senator **Conrad**. I think that would be very helpful to us.

Mr. **Flowers**. Certainly.

CHART 9—BORROWERS BY FARM INCOME/SOLVENCY CATEGORIES AFTER RESTRUCTURING

Our next chart shows the financial strength of the borrowers for operating farms after servicing. We compared the financial profile of the borrowers to the Department of Agriculture's Economic Research Service's criteria for debt-to-asset ratios. If you remember from chart 3, we had 166 borrowers who actually received restructuring offers or primary servicing offers. We looked at 160 of those. We note 6 of the 160 borrowers had a debt-to-asset ratio of less than 40 percent, indicating a favorable financial strength for farming. Also, 79 borrowers, or about 49 percent, had a debt-to-asset ratio exceeding 100 percent.

Senator **Conrad**. I'll tell you, this is the most sobering chart I have seen yet, because this is after restructuring.

Mr. **Harman**. Yes, sir. The next one will not please you also, Mr. Chairman, I don't believe.

Mr. **Flowers**. Looking just at the debt-to-asset ratio by itself doesn't always tell you whether a farmer is going to succeed or fail. Another indication would be the cash-flow, the projected cash-flow. And if we include the cash-flow position of the farmers that we looked at, we could add another nine borrowers to that category that we felt had a favorable position for farming.

CHART 10—BORROWERS BY CASH-FLOW MARGIN AFTER RESTRUCTURING

This table shows that about 59 percent of the 160 had a potential cash-flow of $100 or less after servicing.

This is what concerns us, when we saw these figures, and I think it gets back to something that Farmers Home said earlier about the number of people who are coming back in, because they are going to come back in with these kinds of figures.

Senator **Conrad**. Well, I'll tell you, it confirms more dramatically than anything I could say the testimony I have heard. The testimony in these hearings, especially the ones out in the States, was that the restructurings were done to such a slim cash-flow margin that we're going to be right back in the soup with these people. This clearly confirms that point.

Mr. **Harman**. That's absolutely correct. So I think that the option that needs to be looked at is do we need to give them some more cushion. And of course, if we give them more cushion, then that means it is more write-down, which is a write-down of losses that have already been recognized in the first place, but it would be more write-down. Also, we may force, depending on how you do it, more people into net recovery buyout.

Senator **Conrad**. Yes. I will tell you, you have done an enormous service by bringing these numbers to the attention of the committee. These numbers really tell the story, and it is a pretty sad story. We have a lot of folks out there who are on the brink of going under after we have had this first round of restructurings. We have a very serious, sobering question to answer: Do we want to move those people off the land completely, or do we want to try to give them a chance to make it and continue? It is a very, very clear set of choices that we have.

It does go back to the question posed by the Secretary's proposal to have a cut-off date, and it goes to the question of the one time debt forgiveness, because we clearly structured the restructurings so tightly that these people are on the brink of going under.

Mr. **Harman**. I think it probably goes even beyond those questions. I think it goes to the question that we talked about in earlier hearings about the role, about loanmaking and how tight we want to make loanmaking, the graduation issue. Really, if you get into those questions, I'm not sure the one-time restructuring is quite as important, because if we do a good job up front, and not only that, recognize we are dealing with people who are not financially secure, helping those people in other ways through advice, then the question, once we get into that question, will that be a better process—I think it will. But we have a serious situation here now that is very difficult to deal with.

Senator CONRAD. Yes, it is absolutely a nightmarish situation. You think of the mess we inherited, and everybody working together has gone a long way toward resolving it. The delinquency rate at FmHA, I am told, is going to go way down this year. And yet we are on the brink of another problem. That's what these numbers tell us, isn't it?

Mr. HARMAN. That's what they say.

Mr. FLOWERS. Yes, sir.

Mr. HARMAN. Let me say this, too. I don't think that means that these numbers indicate that the Agricultural Credit Act was in any way a failure in this regard. If we didn't have the Agricultural Credit Act, I think we'd have to look at what our options would have been, and they weren't too good, so——

Senator CONRAD. We had no good options, wouldn't you say, John?

Mr. HARMAN. That's right.

Senator CONRAD. We were faced with—we had a disaster, that's all.

Mr. HARMAN. The act created a mechanism to really write-down bad loans that have already been, for all practical purposes, written off through the accounting process. So I think this raises the question, though, of the process of the administration of the act and how we handle just the process that we determine how far we are going to write people down and how much help we're going to give them.

Senator CONRAD. The question of what we do next is obviously very important. We have dealt with the immediate crisis that we were presented with. We have made good progress on dealing with that. We structured a system that allowed us to move through this. But in doing it, FmHA structured it so tightly that we left a large percentage of these people on the brink of failure. So that raises the question now: Do we push them off the land, or do we try to structure this process in a way that allows them to make it and at the same time provides some transition process so that some of these folks who want to try to do something else have the opportunity to do that.

Obviously, we have a whole lot of folks who are on the brink of personal economic disaster.

Mr. HARMAN. And the approach we are going to use would be either to push them off the land at this point, give them more chance, or we go back into the treadmill of reservicing, reservicing, restructure, write-down—we keep that process going, and we'll be around this table for some time, trying to deal with that problem.

Senator CONRAD. Yes, I suspect we're going to be dealing with this problem in one way or another for an extended period based on these numbers. Whichever way we go, whichever selection of policy choices that we choose, we are faced with a very sobering situation.

I will tell you, in my State, where we are in the third year of drought, it is even more sobering.

Is there anything else?

Mr. HARMAN. There are several other issues that Jess did not mention. Two of them have really been covered, and that is the issue of the bad faith borrowers and the issue of considering unsecured assets as part of the debt relief process.

The other thing we did was we talked about 30 borrowers who were nondelinquent in an attempt to see whether or not the act was providing some sort of incentive to them to become delinquent. And the majority indicated that, yes, it would; there were some bad feelings there, that because they had paid their bills, they weren't getting the benefits of the program. So that is another issue. Now, whether that is going to be a problem, and how that problem is addressed, it can be handled administratively, we'll just have to see.

Senator CONRAD. Did you blame that on Sox?

Mr. HARMAN. Yes, that's definitely Sox.

Senator CONRAD. Tell them we're getting rid of Sox, and that problem should go away.

Mr. JOHNSON. Get me back to Texas.

Senator CONRAD. Yes, we're sending Sox back to Texas. [Laughter.]

Mr. HARMAN. Now, I'd like to just briefly let John Wanska, who has done the preliminary work you asked us to do on the sale of inventory property, to speak to you briefly about that.

Senator CONRAD. Thank you. Welcome, John.

FMHA INVENTORY PROPERTY

Mr. WANSKA. Good morning.

We are currently reviewing the FmHA inventory property, as John said, and in January and February we completed limited work at two county offices, one in Minnesota and one in Iowa.

We looked at 15 properties that had been sold during the period of January 1989 through January 1990 and focused on looking at the capitalization and the market value and the differences between those values, and also in regard to your concern about beginning farmers who actually purchased those properties.

Properties, as you know, can be sold to eligible borrowers at the lesser of the recommended market value or the capitalization value. FmHA regulations further require that if those values vary by 5 percent or more, the appraisal will be further reviewed for support.

CHART 11—COMPARISON OF MARKET AND CAPITALIZATION VALUES FOR INVENTORY PROPERTIES

Looking at our last chart, we have data on the capitalization values and market values for the 15 properties. For seven of the properties, the market value was actually less than the capitalization value. The average difference was just under $1,400, with a range of $100 to $4,400. For five of the properties, capitalization value was less than the market value. The average difference was just over $1,200, and the range from about $160 to just under $3,000. And for three, actually, the market value and the capitalization value were the same.

Senator CONRAD. Could I interrupt you there and ask you what kind of values are we talking about, so we can get some sense of how significant that average value difference is?

Mr. WANSKA. That average value equates in both cases to about 2 percent.

Senator CONRAD. About 2 percent. So we are talking very close, very, very, close——

Mr. WANSKA. Correct, yes.

Senator CONRAD. It is pretty much what you would expect.

Mr. WANSKA. Other factors, such as reduced interest rate, would be more significant in the sale of a property.

Senator CONRAD. This would probably be generally what we would find in the inventory, but you'd find these anomalous situations that were outlined by the Secretary where, let's say you are on the edge of Phoenix, Arizona, and the market value is dramatically higher than the capitalization value. That was not true, obviously, in any of the cases you looked at here.

Mr. WANSKA. That's correct. In fact, we asked the farmer program chiefs of both those States, Minnesota and Iowa, to point us to an example similar to Arizona, and they couldn't find one.

Senator CONRAD. They could not find one. Well, you probably wouldn't find many of them in our part of the country. It would be in those high-growth areas where you would anticipate finding the kind of situation that we ran into in Arizona. Obviously, we have to try to address that.

Mr. HARMAN. And they tend to be very visible in those cases.

Senator CONRAD. Yes, absolutely. All right.

Mr. WANSKA. As far as who purchased those 15 properties, we found that 8 were purchased by existing operators to expand their operations.

Senator CONRAD. Eight were existing operators.

Mr. WANSKA. Yes, and they purchased these properties to expand their operations.

Seven went to the former owners—in other words, they were the buyback option.

In talking with the County Supervisors at these offices, we addressed this question of whether these properties were appropriate for beginning farmers, and they had some questions about it. They thought that many of the properties were in such poor condition as far as the buildings and the land that they were not appropriate for beginning farmers. And also, 7 of the 15 properties had conservation easements placed on them while they were in FmHA inventory. These easements took about 28 percent of the acreage of those seven properties, which is another indication that perhaps farming is not the best use for that part of the property.

Senator CONRAD. Did you get any comments on the effect of those conservation easements? Were there direct comments made to you as to the effect of the granting of those conservation easements on those properties?

Mr. WANSKA. Comments from the County Supervisors, or——

Senator CONRAD. Anybody that you interviewed out there.

Mr. WANSKA. We were looking into the area of conservation easements, and there were concerns in various areas such as the restricted use of the property; another concern was the possible sale of the property once an easement is put on, which stays on the title of the property.

Senator CONRAD. My thought is we may better take a look at this whole question of conservation easements. I have heard a lot of comments—the coffee klatsch kind of conversation—about these easements. But real concern was expressed about what these easements do to the economic viability of some of these units.

Did you hear concerns voiced like that?

Mr. WANSKA. Yes, particularly in the resale area. From the standpoint of a person willing to purchase the property, not an FmHA borrower, but ultimately someone who would purchase it with a regular credit sale or cash sale, whether or not they would want property that has a restriction on it.

Senator CONRAD. All right.

Mr. HARMAN. That concludes our presentation, Mr. Chairman.

Senator CONRAD. As always, you provided an excellent presentation and one that is very useful to us. We appreciate it very much.

Mr. HARMAN. Thank you.

Senator CONRAD. I thank all of you for the work that you have put forward.

[The prepared statement, appendixes I-II, and charts 1-11 of Mr. Harman follow:]

UNITED STATES GENERAL ACCOUNTING OFFICE

GAO

TESTIMONY

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Farmers Home Administration's Implementation of the Agricultural Credit Act of 1987 and Sales of Farm Inventory Property

Statement of
John W. Harman, Director
Food and Agriculture Issues
Resources, Community, and Economic
Development Division

Before the
Subcommittee on Agricultural Credit
Senate Committee on Agriculture,
Nutrition, and Forestry

GAO/T-RCED-90-38

Mr. Chairman and Members of the Subcommittee:

We are pleased to discuss the preliminary results of our work on the Farmers Home Administration's (FmHA) implementation of the debt servicing provisions of the Agricultural Credit Act of 1987 and the sales of farm inventory properties. Our study of FmHA's implementation of the Agricultural Credit Act, which is being conducted at the request of the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, is nearing completion. The Chairman agreed that we could provide the Subcommittee with preliminary results from this work. Our study of farm inventory properties, which is being conducted at your request, was started in January 1990.

In summary, FmHA estimated in March 1988 that debt forgiveness through implementation of the Agricultural Credit Act would total $9.4 billion. As of November 30, 1989, approved debt forgiveness totaled $1.8 billion.

Our preliminary work on FmHA's implementation of the debt servicing provisions of the Agricultural Credit Act at 10 county offices showed that:

-- slightly over one-third of the eligible delinquent borrowers qualified to (1) have their debt restructured or (2) pay FmHA an amount equal to the adjusted value of the collateral securing the debt--referred to as net recovery value buy-out. Nearly all of the remaining borrowers did not apply for servicing or did not submit complete applications.

-- about 35 percent of the borrowers who qualified for servicing were offered restructuring, with and without debt write-down, and about 65 percent were offered net recovery value buy-out. Borrowers' debt obligations to

FmHA are ended if they pay the buy-out amount, which is usually much less than the amount of their outstanding debt.

-- only 9 percent of the restructured borrowers had favorable financial potential for future successful farming operations. The remaining 91 percent of the restructured borrowers had such high debt-to-asset ratios and/or low cash flow margins that their potential appeared limited for successful farming operations without continued FmHA financial assistance.

-- borrowers whose delinquency was due to circumstances within their control or who did not act in good faith in connection with the terms of their FmHA loans--referred to as bad faith borrowers--have been allowed to buy out their FmHA debt at the net recovery value of their collateral and receive substantial debt write-offs. Also, bad faith borrowers will be eligible to reacquire their farmland, or farm homestead, if FmHA forecloses on their properties.

-- FmHA does not consider unsecured assets in computing the amount and type of debt relief to offer borrowers. The act does not require FmHA to consider unsecured assets, but not doing so reduces the debt recovery by the government.

-- nondelinquent borrowers may seek the act's benefits by becoming delinquent on their FmHA loans in the future.

Our limited work on FmHA sales of farm inventory properties at two FmHA county offices showed that the market value and productivity value differ on the average by about two percent for the FmHA properties we reviewed. Furthermore, most properties were sold to farmers to expand existing farming operations.

In presenting this testimony, I will refer to several charts with statistics that we developed on both assignments. Appendixes I and II provide these detailed statistics.

FmHA'S IMPLEMENTATION OF THE DEBT SERVICING PROVISIONS OF THE AGRICULTURAL CREDIT ACT

We initiated a study in December 1988 evaluating what actions FmHA was taking to implement the debt servicing provisions of the Agricultural Credit Act of 1987 and the impact of implementation on the agency's farmer program delinquent borrowers. Our report on this work will be issued to the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry in the spring of this year.

Throughout 1989, we discussed debt servicing activities with FmHA headquarters and field officials and reviewed the debt servicing actions of 10 FmHA county offices--one in each of the 10 selected states. We selected the 10 states with the largest number of debt servicing notification packages sent by FmHA to delinquent borrowers. The 10 states, in order of the number of notification packages sent, are: Texas, Mississippi, Louisiana, Georgia, Minnesota, Missouri, Oklahoma, North Dakota, Tennessee, and South Dakota. We selected one county office with a high number of delinquent borrowers in each state. The results of our work apply only to the offices we reviewed and cannot be projected to the 10 states or the nation overall.

Background on the Agricultural Credit Act

In January 1988, when the Agricultural Credit Act was enacted, FmHA estimated that borrowers were delinquent on $11.4 billion of its $26 billion direct farm loan portfolio. According to the agency, about 85,000 of its 242,000 farmer program borrowers were delinquent and another 33,000 were in bankruptcy, foreclosure, or some other "inactive" status.

The Agricultural Credit Act allowed FmHA to use several loan servicing options to restructure or reduce debts of farmer program borrowers who were 180 days or more delinquent. FmHA can restructure a delinquent borrower's debt, including writing down debt, to an adjusted value of the collateral securing the debt (net recovery value). Borrowers who are unable to develop a feasible plan of operations with restructuring can pay FmHA the net recovery value buy-out amount and end their FmHA debt obligation. Furthermore, borrowers can reacquire their farms or farm homesteads from FmHA in the event of foreclosure under the act's preservation servicing program.

FmHA designed a computer program for county offices to use in analyzing key information to determine how borrowers' loans could be serviced. The program compared the present value of borrowers' restructured loans with the net recovery value of the collateral securing the loans. The act provided for restructuring when the present value of a borrower's restructured debt equaled or exceeded the net recovery value the government would receive from foreclosure and liquidation of the collateral. Conversely, the act provided for buy-out when the present value of the restructured loans was less than the net recovery value of collateral.

Servicing Notifications and Applications

The preliminary results of our review showed that in November 1988 FmHA mailed notices of the act's loan servicing options to more than 66,400 borrowers who were 180 days or more delinquent. On a national basis, about 50 percent of those notified applied for servicing. Chart 1 shows that at the 10 county offices we reviewed, 1,272 borrowers were initially notified of the options.

Of the 1,272 eligible borrowers, 569, or 44 percent, applied for servicing.

Chart 2 shows that at the county offices we reviewed, borrowers did not apply for servicing primarily because they (1) were inactive borrowers who generally were no longer farming, (2) chose to negotiate a settlement of their FmHA debt rather than servicing under the act, or (3) chose to pay their FmHA delinquent debt current or in full.

Servicing Decisions

Nationally, as of June 30, 1989, FmHA offered restructuring with debt write-down and buy-out with debt write-off to 7,509 borrowers. At that time, FmHA had not compiled national statistics showing the number of borrowers who were restructured without debt write-down. In January 1990, FmHA reported that, as of November 30, 1989, the number of serviced borrowers had increased to 9,637 borrowers--4,608 borrowers offered restructuring with debt write-down and 5,029 borrowers offered buy-out with debt write-off. An additional 9,599 borrowers were offered restructuring without debt write-down.

At the county offices we reviewed, chart 3 shows that, as of June 30, 1989, 474 borrowers qualified for servicing and 8 borrowers had eligibility decisions pending. Chart 4 shows that county staffs denied servicing for 87 of the 569 borrowers for a variety of reasons; the primary reason was that the borrowers submitted incomplete applications.

Of the 474 borrowers who qualified for servicing, 166 borrowers were offered restructuring and 308 borrowers were offered buy-out. However, 5 of the 166 borrowers who were offered restructuring did not accept the offers and 35 of the 308 borrowers offered buy-out did not accept the offers or were involved in mediation at the time of our review. Of the 161 restructured borrowers, 84 were restructured without debt write-down and 77 were restructured with debt write-down.

Amount and Type of Debt for Serviced Borrowers

Borrowers with large, moderate, and small amounts of FmHA debt, and with most types of FmHA farm program loans, were serviced. For example, chart 5 shows that while 19 borrowers at the county offices we reviewed had FmHA debt of $1 million or more before servicing, 243 borrowers had FmHA debt of less than $250,000. Also, chart 6 shows that 61 percent of the borrowers had a combination of loan types which included an emergency loan (economic and/or disaster) and at least one other loan type, such as a farm ownership or a farm operating loan. While 15 percent of the borrowers had only emergency loans, 24 percent did not have an emergency loan.

Costs of Servicing

Implementation of the Agricultural Credit Act has been at a substantial cost to the government. In March 1988, FmHA estimated that debt forgiveness through write-downs and write-offs would total $9.4 billion. Nationally, as of June 30, 1989, FmHA had approved write-downs and write-offs that total almost $1.4 billion. In January 1990, FmHA reported that, as of November 30, 1989, approved debt forgiveness had increased to a total of $1.8 billion.

Chart 7 shows that at the county offices we reviewed, $91 million, or almost two-thirds of the total $139 million debt of delinquent borrowers who were offered servicing, was written down or written off. The write-down offered 77 restructured borrowers totaled $13 million, or about $169,000 on average, and the write-off offered 273 buy-out borrowers totaled $78 million, or about $286,000 on average. The amount of debt that FmHA offered to write down or write off for the 350 borrowers in these county offices varies widely. For example, chart 8 shows that while the offers to 114 borrowers would result in $250,000 or more forgiven--including 10 borrowers with $1 million or more forgiven--the offers to 236 borrowers would result in less than $250,000 forgiven.

The following case illustrates the costs of debt servicing. A borrower, who is no longer farming, owed FmHA almost $805,000 on 10 natural disaster emegency and three farm operating loans. He had about $73,000 worth of equipment as collateral for the 13 loans. He had not made a payment to FmHA on the emergency loans since 1983 and on the farm operating loans since 1985. FmHA offered to write off $738,928 of his debt.

Financial Soundness of Restructured Borrowers

At the time of our field work, data was available to analyze the financial condition of 160 of the 161 restructured borrowers. Our analysis indicates that 9 percent of the 160 restructured borrowers had favorable financial potential for successful farming operations. The remaining 91 percent had such high debt-to-asset ratios and/or projected low cash flow margins for the upcoming year that their potential for successful farming operations without continued financial assistance appeared limited. For example, chart 9 shows that 77 percent of the restructured borrowers had debt-to-asset ratios of 71 percent or higher--nearly one-half of the 160 borrowers were technically insolvent with debts exceeding assets. Chart 10 shows that 59 percent of the restructured borrowers had cash flow margins of $100 or less. One restructured borrower had a $2 cash flow, a 222 percent debt-to-asset ratio, and a $246,000 negative net worth after restructuring which included a $50,000 debt write-down.

FmHA stops analyzing a borrower's restructuring options as soon as a positive cash flow is reached. This is the point at which the present value of the restructured loans equals or exceeds the recovery the government would receive from an involuntary liquidation or foreclosure on the security. However, this approach is a primary reason many borrowers remain financially weak following restructuring.

In addition, FmHA based its restructuring decisions on borrowers' projections of farm income and expenses which may not accurately reflect borrowers' financial conditions. FmHA state and county officials we interviewed in each selected state expressed concern about the ability of some restructured borrowers to continue farming operations without continued FmHA financial support. Also, some restructured borrowers expressed concern about their ability to repay their restructured debt and to continue farming without additional FmHA financial assistance. Furthermore, about 14 percent of the 569 borrowers who applied for servicing at the 10 county offices we reviewed requested additional FmHA loans at the time they applied for servicing.

Borrowers Who Act in Bad Faith Are Eligible for Some Servicing

FmHA borrowers who act in bad faith[1] are not eligible for restructuring, but they are eligible for net recovery value buy-out and for reacquiring their farms through the leaseback/buyback option or their farm homesteads through the homestead protection option. As part of our work examining implementation of the

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[1] We use the phrases "borrowers who act in bad faith" and "bad faith borrowers" to refer to those FmHA delinquent borrowers whose delinquency was due to circumstances within their control or who did not act in good faith in connection with the terms of their FmHA loans.

Agricultural Credit Act, we issued Farmers Home Administration: Loan Servicing Benefits for Bad Faith Borrowers (GAO/RCED-90-77FS, Nov. 29, 1989). This report provides examples of FmHA delinquent borrowers who have acted in bad faith and who have received benefits, or will be eligible to receive benefits, under the provisions of the act.

FmHA determined that borrowers acted in bad faith because of various actions, such as (1) selling or otherwise disposing of property that was securing loans without FmHA approval; (2) repaying other lenders more than required and, at the same time, becoming delinquent on FmHA loans; (3) abandoning the property that was securing FmHA loans; and (4) having resources available that could have been, but were not, used to make FmHA loan payments.

In January 1990, FmHA provided members of Congress with a list of 218 bad faith borrowers throughout the country that it said had committed fraud, waste, or conversion of security property and who were involved in net recovery value buy-outs. Forty-two of those borrowers had bought out their debt at a net recovery value and 58 other borrowers were in the process of buying out their debt. These borrowers have bought out, or have the opportunity to buy out, their debt for much less than the amount of their outstanding debt. These 100 borrowers include 8 borrowers who bought out or were in the process of buying out their debt that will result in a write-off of more than $1 million each. For example, one borrower who FmHA said committed fraud owed $11.8 million and was offered a $1.1 million net recovery value buy-out. This borrower will receive a $10.7 million write-off of his FmHA debt if he pays the buy-out amount. In addition, 118 borrowers on the national list were offered net recovery value buy-out, but they did not accept the buy-out offer. These borrowers will be eligible to reacquire their farmland, or farm homestead, if FmHA forecloses on their properties.

Assets Which Do Not Secure FmHA Debt Are Not Considered in Servicing Decisions

The Agricultural Credit Act does not provide FmHA specific authority to include unsecured assets in calculating servicing for delinquent borrowers. As a result, FmHA does not consider borrowers' assets that are not pledged as security for FmHA debts when computing the type and amount of debt relief to offer delinquent borrowers. Excluding unsecured assets in servicing computations increases the amount of debt forgiveness and reduces the amount of recovery FmHA receives when borrowers buy out their debt at the net recovery value of collateral.

The following case illustrates borrowers who had unsecured farm and nonfarm assets that were not considered in calculating the net recovery value buy-out amount. In this example, the FmHA county supervisor did not consider a borrower's unsecured assets of $21,000 in cash and 19 acres of land that the borrower had reported on his servicing application. In June 1989, the borrower paid FmHA $72,405--the net recovery value buy-out amount--to settle his outstanding debt of $166,000. The borrower received a $93,595 debt write-off. FmHA would have saved at least $21,000 if it had applied this cash amount to reduce the borrower's debt in processing his restructuring application. The borrower would still have qualified for net recovery value buy-out, but the government's loss would have been less. Also, FmHA might have realized additional savings by considering the value of the borrower's 19 acres of unsecured land.

Nondelinquent Borrowers May Seek the Act's Benefits

FmHA borrowers who are current on their loan payments are not eligible for the restructuring with debt write-down or net recovery value buy-out with debt write-off options of the Agricultural

Credit Act. Some borrowers and FmHA officials told us that since the act provides benefits only to delinquent borrowers it has created an incentive for nondelinquent borrowers to become delinquent on their FmHA debt to qualify for loan servicing. Some nondelinquent borrowers told us that they were looking for ways to become delinquent in order to have their FmHA debt reduced. Borrowers who intentionally become delinquent may be disqualified from restructuring if county office staff determine that they caused their delinquency by not using available resources to pay their FmHA debt. However, FmHA county supervisors may be unable to deny debt servicing to such borrowers because of difficulties in concluding that borrowers caused their own delinquencies.

Nondelinquent borrowers, upon seeing that delinquent borrowers have their cost of farming reduced through the various servicing options, may also seek to qualify for the act's benefits. For example, a borrower who was current on his $451,028 FmHA debt had annual payments of $48,765. A delinquent borrower in the same community, who had FmHA debt of $932,940, had an annual payment of about $81,625. The delinquent borrower was about $163,250 behind in payments. FmHA forgave the delinquent borrower's entire debt through a $0 net recovery value buy-out. As a result, the delinquent borrower has no FmHA loan payments, but the current borrower must continue to pay his $48,765 annual payment.

SELLING PRICE OF FmHA FARM INVENTORY PROPERTY

As you know, we initiated a study in January 1990 to evaluate the sale of farm inventory property at a fair market or capitalization (productivity) value and the impact of the sales price on beginning farmers. During January and February 1990, we held discussions with FmHA headquarters officials and state officials in Minnesota and Iowa, and reviewed farm inventory property sales at two FmHA county offices--one in Minnesota and one in Iowa. The results of this work to date are limited and apply only to the offices we reviewed; they cannot be projected to the two states we visited or the nation overall.

The Food Security Act of 1985 and the Agricultural Credit Act provide FmHA with guidance on selling farm inventory property. The Food Security Act provides that FmHA sell farm inventory property to operators of not larger than family-size farms. The Agricultural Credit Act provides FmHA with a ranking order for selling property to previous borrower-owners, members of their families, previous operators, or other family-size farm operators. Borrowers whose real property has been taken into FmHA inventory have the option of purchasing the entire farm property (this is referred to as the buyback option) or the farm homestead, including farm buildings and up to 10 acres of land (this is referred to as the homestead protection option).

Farm inventory property is sold to FmHA-eligible borrowers and operators of family-size farms at the lesser of market value or capitalization value--a price that reflects the average annual income that may reasonably be generated from farming the property. Homestead property, on the other hand, is sold at the market value of the property.

In pricing farm property, FmHA makes an appraisal which consists of three estimates of property value in determining a recommended market value. The first estimate is based on comparable property sales, the second on income generated from both comparable properties sold and the appraised property, and the third is a summation value of land by soil type and buildings on the land.

In calculating the capitalization value, a capitalization rate is determined based on the income generated from comparable properties sold. This rate is stated as a percent and is calculated by dividing the net income from a comparable property by the sales price. To determine the capitalization value for the appraised property, the expected net income from the property is divided by the capitalization rate.

The three appraisal values--the comparable market value, capitalization value, and summation value--are then considered in determining a recommended market value. The final property price is then the lower of the capitalization value or the recommended market value. If the recommended market value and the capitalization value vary as much as five percent, FmHA regulations require that the appraisal will be reviewed by an appraiser designated by the FmHA state director to determine if the appraisals are supported by comparable sales data.

We examined the selling price of 15 properties in two county offices. These properties had an average 170 acres and were sold at an average price of $66,172 during the period January 1989 through January 1990. Chart 11 shows that for 7 of the 15 properties, the market value was less than the capitalization value by an average of $1,374 or about 2 percent of the $57,000 average selling price. The difference in values ranged from $100 to $4,400. For 5 of the properties the capitalization value was less than the market value by an average of $1,247 or about 2 percent of the $70,115 average selling price. The difference in values ranged from $162 to $2,884. For the remaining 3 properties, which had an $81,000 average selling price, the market and capitalization values were the same.

Eight of the 15 properties were purchased by farmers to expand their existing operations and 7 were purchased by the former owner and FmHA borrower. Of the 8 purchased to expand operations, 2 were farmers who were leasing property for existing operations and were purchasing land for the first time. County supervisors at both offices we visited stated that inventory properties are generally not appropriate for beginning farmers because of the poor condition of the property, such as farm buildings that had deteriorated and land that had not been cultivated in a number of years. Also, the properties may be better suited for other non-farming purposes as illustrated by 7 of the properties which had conservation easements placed on them while in FmHA inventory. These 7 properties had a total of 1,270 acres, but 354 acres, or 28 percent, were placed under easement. In one case, the entire property, consisting of 80 acres, was placed under easement.

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In conclusion, our preliminary work on FmHA's implementation of the debt servicing provisions of the Agricultural Credit Act at 10 county offices showed that while many delinquent borrowers have been offered restructuring or net recovery value buy-out, most delinquent borrowers did not apply for servicing or did not submit complete applications. Many of the borrowers who qualified for servicing were offered restructuring, with and without debt write-down, however, most serviced borrowers were offered net recovery value buy-out. Our work also showed that only a small percentage of the restructured borrowers had favorable financial potential for future successful farming operations. The vast majority of restructured borrowers do not have such potential without continued FmHA financial assistance.

Furthermore, bad faith borrowers have been allowed to buy out their FmHA debt at the net recovery value of their collateral, which is usually much less than their outstanding debt. Bad faith borrowers will also be eligible to reacquire their farmland, or farm homestead, if FmHA forecloses on their properties.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions.

STATISTICAL INFORMATION ON DELINQUENT BORROWERS AT 10 FmHA COUNTY OFFICES REVIEWED BY GAO

Chart 1: Eligible Borrowers Who Applied for Debt Relief

	Borrowers eligible to receive packages	Borrowers initially sent packages	Borrowers applied for servicing	Percent of eligible borrowers applied for servicing
Number of borrowers	1,293	1,272[a]	569	44

[a] Notification packages were subsequently sent to 14 of the 21 additional eligible borrowers. Our analysis was based on 1,272 borrowers who were initially sent notification packages.

Chart 2: Reasons Borrowers Did Not Apply for Servicing

	Inactive farmers[a]	Requested debt settlement[b]	Repaid debts[c]	Reason unknown	Total[d]
Number of borrowers	309	155	67	172	703
Percent of nonapplying borrowers	44	22	10	24	100

[a] Includes those borrowers who are no longer farming and those in bankruptcy, foreclosure, or collection-only status with little or no collateral.

[b] According to FmHA officials, borrowers who requested debt settlement usually are no longer farming.

[c] Includes borrowers who paid their delinquent debt current and those who repaid their total outstanding debt.

[d] We did not determine the reason all borrowers did not apply for servicing. However, 5 of the 35 borrowers we interviewed told us they were confused by FmHA's notification and application package.

Chart 3: Borrowers Who Had Debt Servicing Offered and Completed as of June 30, 1989

	Primary servicing		Net recovery value buy-out		Total	
	Offered	Completed	Offered	Completed	Offered	Completed
Number of borrowers	166	96	308	95	474[a]	191

[a] In total, 569 borrowers applied for servicing; the 474 total does not include servicing offers that were pending for 8 borrowers and servicing that was denied for 87 other borrowers as of June 30, 1989.

Chart 4: Reasons Borrowers Were Denied Servicing

	Ineligible				
	Incomplete application	Borrower deceased[a]	Borrower caused delinquency[b]	Other[c]	Total
Number of borrowers	65	8	7	7	87
Percent of borrowers	75	9	8	8	100

[a] Deceased borrowers' estates that applied for servicing are not eligible for primary servicing but may qualify for preservation servicing.

[b] These borrowers were not eligible for primary servicing and did not qualify for net recovery value buy-out.

[c] Includes borrowers who did not meet FmHA eligibility requirements for various reasons, such as failure to reaffirm their debt after bankruptcy.

Chart 5: Borrowers by Range of Borrower Debt Prior to Loan Servicing

	Range of Debt (Dollars in Thousands)					
	$1 to $99	$100 to $249	$250 to $499	$500 to $999	$1,000 and over	Total[a]
Number of borrowers	106	137	127	45	19	434
Percent of borrowers	24	32	29	10	4	100[b]

[a] We did not record debt prior to servicing for 40 eligible borrowers in two counties who had declined FmHA's servicing offer or were in mediation. We also did not record information for the eight borrowers whose servicing offers were pending.

[b] Total does not add due to rounding.

Chart 6: Serviced Borrowers by Type of Loans

	Borrowers with no emergency loans	Borrowers with only emergency loans	Borrowers with a combination of loans	Total[a]
Number of borrowers	106	64	264	434
Percent of borrowers	24	15	61	100

[a] We did not determine loan type for 40 eligible borrowers in two counties who had declined FmHA's servicing offer or were in mediation. We also did not record information for the eight borrowers whose servicing offers were pending.

Chart 7: Borrowers and Amount of Debt; Debt Reduction, by Servicing Category

Dollars in millions

	Primary servicing		Net recovery value	
	Without write-down	With write-down	buy-out	Total[a]
Number of borrowers	84	77	273	434
Percent of borrowers	19	18	63	100
FmHA debt before servicing	$13	$26	$100	$139
FmHA debt written down or off	—	$13	$78	$91

[a] We did not compile servicing information for 40 eligible borrowers in two counties who had declined FmHA's servicing offer or were in mediation. We also did not compile information for the eight borrowers whose servicing offers were pending.

Chart 8: Borrowers by Range of Write-downs and Write-offs

	Range (Dollars in Thousands)					
	$1 to $99	$100 to $249	$250 to $499	$500 to $999	$1,000 and over	Total[a]
Number of borrowers	121	115	75	29	10	350
Percent of borrowers	35	33	21	8	3	100

[a] We did not compile servicing information for 40 eligible borrowers in two counties who had declined FmHA's servicing offer or were in mediation. We also did not compile information for the eight borrowers whose servicing offers were pending.

Chart 9: Borrowers by Farm Income/Solvency Categories After Restructuring

	Favorable	Marginal solvency			
	0-40%	41-70%	71-100%	Over 100%	Total[a]
Number of borrowers	6	30[b]	45	79	160
Percent of borrowers	4	19	28	49	100

[a] Excludes five borrowers who did not accept restructuring offers and one borrower whose financial data was not available at the time of our review.

[b] Nine of these 30 borrowers had a high cash flow margin, suggesting a more favorable potential for successful farming operations than indicated solely by their debt-to-asset ratio. These nine borrowers when combined with the six borrowers in the favorable category results in a total of 9 percent of the 160 restructured borrowers having the potential for successful farming operations.

Chart 10: Borrowers by Cash Flow Margin After Restructuring

	Positive Cash Flow Margin					
	$0 to $10	$11 to $100	$101 to $1,000	$1,001 to $10,000	$10,000 and over	Total[a]
Number of borrowers	63	32	15	30	20	160
Percent of borrowers	39	20	9	19	13	100

[a] Excludes five borrowers who did not accept restructuring offers and one borrower whose financial data was not available at the time of our review.

STATISTICAL INFORMATION ON FARM INVENTORY SALES AT 2 FmHA COUNTY OFFICES REVIEWED BY GAO

Chart 11: Comparison of Market and Capitalization Values for Inventory Properties

Valuation relationship	Number of properties	Average value difference	Range of value difference
Market value less than capitalization value	7	\$1,374[a]	\$100 to \$4,400
Capitalization value less than market value	5	\$1,247[a]	\$162 to \$2,884
Market value equals capitalization value	3	--	--

[a] Equals 2 percent of the average selling price.

Senator CONRAD. Next, we'll hear from Lynn Hayes, the Minnesota Project Director of the Farmers' Legal Action Group.

Welcome, Lynn.

STATEMENT OF LYNN A. HAYES, ATTORNEY, MINNESOTA PROJECT DIRECTOR, FARMERS' LEGAL ACTION GROUP, INC., ST. PAUL, MN

Ms. HAYES. Thank you, Mr. Chairman, for the opportunity to testify today.

INTRODUCTION

I am Lynn Hayes. For those of you who don't know, I am an attorney with the Farmers' Legal Action Group, and we are a nonprofit organization that has been representing farmers around the country for 3 or 4 years now. I have been working with FmHA borrowers for about 8 years now.

TESTIMONY TO CONCENTRATE PRIMARILY ON THE ADMINISTRATION'S PROPOSALS FOR AMENDMENTS TO THE AGRICULTURAL CREDIT ACT

In my testimony today, I am going to concentrate primarily on the administration's proposals for amendments to the Agricultural Credit Act. The approach I want to take here is to keep in mind what the public policy purposes of the 1987 act were, how the act actually implemented those policies, and then what the implications of the administration's proposed changes would be both on the furtherance of those public policies, on family farmers, and on the Federal budget.

THE PUBLIC POLICY PURPOSES OF THE 1987 ACT

First of all, just very briefly—Mr. Chairman, you have already referenced many of these things today—but briefly, it is absolutely clear from the legislative history that the intention of the 1987 act was to help preserve family farms in this country and to do it in a fiscally responsible fashion. Obviously, we are always looking at financial constraints on the Federal budget. And the way the act was designed was to ensure that to the extent that it would cost the Government no more to keep that farmer farming, we were going to keep him on the land rather than foreclose on him and lose additional money for the taxpayers. I think that is absolutely imperative to keep in mind when we are looking at any changes in the act itself to make sure we are not gutting that intention and purpose of the act by making these changes.

The act was also designed not just to respond to the economic crisis of the eighties but to be a form of program that would be there in good times and bad times and that it would work effectively and viably in both situations. Therefore, we should keep in mind that we don't want to take that long-term aspect of the act away if we don't absolutely have to.

HOW THE 1987 ACT EFFECTUATES THE PUBLIC POLICY PURPOSES

Now, the way that the act effectuates these public policy purposes—and I am going to concentrate primarily on the debt restructuring provisions since that appears to be what most of the discussion and debate is about now. Basically, what the act did was require the agency to do two calculations designed to get a realistic picture of what the Government would collect, number one, if it restructured the loan and kept the farmer there. The way they do that is through what is called the present value of the restructured loan, where they look at the amount the farmer could afford to pay, figure out what the value of that stream of payments that he could afford to pay would be. So that is the present value of the restructured loan.

The other calculation they were required to do is the net recovery value calculation, which is designed to give them an accurate reflection of what the Government would actually collect on that loan if they foreclosed and liquidated the collateral on the loan.

There are, of course, also two other eligibility criteria for the debt restructuring portion—the good faith eligibility and the circumstances beyond your control—which have both been discussed at some length here.

I think that it should be noted that currently under the act, a borrower could get more than one write-down, but the borrower would only get an additional write-down if the Government would still get just as much or more from that borrower than they would if they foreclosed and liquidated the loan account.

Again, as you have mentioned, Senator Conrad, it is clearly designed, and I think it works effectively, with some loopholes that are there that we need to tighten up, that the act and the general purpose of the act works, and it works beyond a one-time write-down.

ANALYSIS OF INDIVIDUAL PROPOSED REVISIONS TO THE 1987 ACT

Let's look at each of the provisions of the administration's proposal, briefly, and see what the implications would be both on these policy purposes and on the Federal budget.

ONE-TIME WRITE-DOWN

First of all, I think we want to take a look at the one-time write-down limitation. The thing that needs to be kept in mind here—and I developed a little chart [13] which is at the back of the testimony to help us pinpoint really what the implications of each of these proposals would be, if you want to take a look at those—with regard to the one-time write-down, the most important thing to keep in mind is that this will actually cost the taxpayers additional money. There will be additional losses to the Government if we limit the one-time write-down. It is not a taxpayer savings. And in addition to that, it is not only not a taxpayer savings, but it will force family farmers off their land. In other words, it is the exact opposite of the policy purposes for the 1987 act—instead of saying we are going to keep those farmers on the land if it doesn't cost us any additional money than we have already lost, we're going to keep them there. This is the exact opposite. What this says is we are going to spend money to force them off their land. And that's what the one-time write-down will do. So it is exactly contrary to the public policy purposes of the 1987 act.

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[13] See p. 494 for the chart, "Effects of the Administration's Proposed Amendments to the FmHA Provisions of the 1987 Ag Credit Act."

Now, just so you understand why that is the implication of a one-time write-down, first of all, under the existing act, if a borrower needs a write-down more than once, they are only eligible for that write-down if they would be paying the Government at least as much as they would get through foreclosure. And in many cases, they may still be paying more than what the Government would get through foreclosure. By definition, then, if they cannot cash-flow without that additional write-down, they are out; if they cannot bring that loan up-to-date, they are going to get foreclosed on. That's the bottom line. They are going to be out if you limit it to a one-time write-down, even though with a second write-down they may still in some instances be paying the Federal government more than they would get if they actually went through with the foreclosure.

So in any case where the second case or even further write-downs would mean that the borrower was still paying the Government more than they would get, in other words, the present value of the restructured loan was higher than the net recovery value, in every single one of those cases not only is the farmer going to lose his farm, but it is going to cost the taxpayers additional money. I think we need to keep that in mind with the one-time write-down. We would recommend that there not be a one-time limitation.

If, however, there is going to be a one-time limitation—I hope not—there are some exceptions that would maintain the viability of the 1987 act and continue the intent and purposes of that act. That is, first, acceptance that will recognize what the real implications of this is, that farmers will lose their farms, and it is going to cost money, and to get at some of the issues and basically say that unless it is really the farmer's fault that he needs this additional write-down, that we are not going to deny him the write-down. Currently, I believe that they could possibly take care of that under the "circumstances beyond your control" language in the existing act. I think they would have to make amendments in their regulations to do that; they would have to go through another proposed comment and rulemaking procedure. But you should know that they have not yet issued their final regulations on these provisions of the act, and at least from the indications that we are getting, they don't expect to issue those until June or July. There is clearly adequate time to go through another proposed comment period if necessary.

But the kinds of exceptions that we would want to look at, I think, to ensure that we are not punishing farmers for something that truly is not their fault here is to limit the one-time write-down or make an exception to the one-time write-down for declines in agricultural land values. If we have another situation like we did in the early and mideighties, farmers can't do anything about that; they are not going to be able to produce the income to even pay for their first time restructuring. So you should limit those kinds of things.

The other thing gets at the issue that we have talked about in a couple of contexts here this morning, and that is how tightly they restructured those loans, that there is no excess cash-flow there. So

I think that if you were going to have a one-time write-down, there should also be an exception where the commodity prices, the income and expense projections that Farmers Home required those farmers to use in their debt restructuring applications, if the farmers did not actually meet those required commodity prices and so forth, that that should be an exception to the one-time write-down rule.

The other ones I have listed on page 8 [14] of my testimony, and I won't go through all of them, but they have to do with other circumstances beyond the control of the borrower, and in fact they were actually taken directly from the FmHA's regulatory definition of "circumstances beyond your control".

Just in summary, I think it is important, and we believe there is no need for a one-time write-down, since the act currently works to ensure that the Federal Government will get maximum return on their investment in this process. But if it is, the exception should clearly be considered, and I think they need to be put in statutory language and not left to the agency to interpret.

$250,000 LIMITATION ON THE WRITE-DOWNS

The next proposal is the $250,000 limitation on the write-downs. Again, this works very similar to the one-time write-down. It will cost the Government additional money, and it will force family farmers off the land—again, completely contrary results to the public policy purposes of the 1987 act. And I don't think that that should be denied if this kind of action is taken.

Now, again, the reason that this works is that currently, again, if a borrower was under the current law eligible for more than a $250,000 write-down, it is because he can't cash-flow without it. If he could cash-flow without it, he wouldn't be eligible for any more than the $250,000. That means that if he can't get the $250,000, the denial of the additional write-down isn't just saying you just don't get that additional benefit—it is saying you lose your farm because you are not going to be able to bring that loan account up.

Now, it is going to cost the Government money for all of those people who would be paying even with a larger than $250,000 write-down, if people would be paying more than the Government would get in a foreclosure or liquidation, every single one of those people, there would be an additional loss to the Federal Government.

Senator CONRAD. May I intercede and just ask you—we would be pushing these people into bankruptcy, I assume, in which the Federal Government would then stand to recover even less, so the Federal Government would not only have the foreclosure; the Federal Government would have the cost of the legal action as well.

Ms. HAYES. I think that is exactly right. All of these people, the last ditch effort to save those farms is going to be to file a bankruptcy action. That again was one of the specific reasons the 1987 act was put into place, to stop the unnecessary filing of those bankruptcy actions. Bankruptcy not only costs the farmer a lot of money, it costs the Government a lot of money in attorney time and so forth. And realistically, the Government will not get any more in the bankruptcy than, say, the net recovery value.

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[14] See p. 486 for the material.

Senator CONRAD. Could I just intercede here and ask Mr. Harman or Mr. Ebbitt if either of you have looked at FmHA's calculations to determine whether it accurately estimates what we get from foreclosure. Have either of your agencies looked at that?

Mr. HARMAN. No, we have not looked at that.

Mr. EBBITT. We haven't either, Mr. Chairman.

Senator CONRAD. I'm thinking that that is something that we'd better do, too. We need to go back to reality—our calculations of what happens when we go to foreclosure, and in fact what is happening.

Sox, do you have any feel for that?

Mr. JOHNSON. No, I do not. But I do—and there may be one other point that you'd like for them to look at—it would be interesting to me because from her comments, I'm taking it that her entire premise was that everything was frozen at the time we got 1951-S; that we are not extending more money to those borrowers that are not likely to ever succeed. You see, we have defined, we agreed that the credit management, we'd like to get that on up there. I personally have indicated a number of times that I'd like to see us have at least that 10 percent cushion such as we have in guaranteed lending, and that's where we have to get. But you see, right now, we are defining for our employees that there only has to be $1 cash-flow. You have already seen these numbers this morning.

But there are two things that are going on while we are buying time——

Senator CONRAD. Sox, you can make that point, but first let me just rivet on the last point that you made. What you are saying is that we don't have enough cushion in here to try to make sure that the first write-down is the last.

Mr. JOHNSON. That's correct.

Senator CONRAD. We should have a cushion in there.

Mr. JOHNSON. And we should have a cushion on all those loans that we are continuing to make. Now that we have a lot of other controls, I am maintaining there should be more cushions all the way around in our lending. Certainly, it would help these people. We'd do more write-down, but I think we're going to write a lot of these off in time.

And there are two things that are still going on with all of those who we are letting buy time to see if they can succeed, and that is we are either giving up our security by other subordinations, or we are continuing to make operating lines of credit to them because they have cash-flowed $1, and many of these will never succeed. That's the point I wanted to make.

Senator CONRAD. That's a guaranteed failure. What we're doing if we don't adjust this is assuring a guaranteed failure.

John.

Mr. HARMAN. Let me just make two comments. One is that I just went through our list that I have before me of the 160 borrowers that Jess talked about before, and unless I am wrong, I have counted 19 borrowers that would not be written down to the extent they were because of the $250,000 limit. And the highest cash-flow of those 19 borrowers after restructuring was $25. So I think you can see that those people probably if written down more than that $250,000 would be going into net recovery value, into some sort of bankruptcy. That is the dilemma that is faced here.

The other comment I would make is on the issue you raise in terms of what is happening as a result of foreclosure. We do have plans for an assignment that would look at some aspects of this act, some additional aspects that we could include as part of that, and we can work with the OIG on that.

Senator **Conrad**. All right. Would you do that? I think it is very important that we really have a clear set of facts for all of us to make judgments on. One would be what do we get when we go to foreclosure compared to what our calculations say we'll get, and what do we get on a net recovery buyout of the farmer versus what we'd get if we'd go out in the marketplace.

I think these are the kinds of things we ought to take a very close look at, and that would help us all.

Sox.

Mr. **Johnson**. Mr. Chairman, if I might ask, on the 10 percent—I believe I'm correct on this, that we actually proposed that in our regulations to implement the 1951-S. However, the overwhelming comments that came in to the regulations is what resulted in it being taken out of the regulations. But we had requested that we have that 10 percent cushion we were talking about a few moments ago. I believe that's correct, isn't it?

Mr. **Harman**. I think that's correct, Sox.

Mr. **Hunt**. I think it may have been 5 percent. Do you remember?

Mr. **Johnson**. I don't know.

Senator **Conrad**. OK.

Ms. **Hayes**. With the indications from GAO that the numbers would indicate out of the 160 only 19, I think if you brought that across the country, there would be at least a significant number of people who would be eliminated by the $250,000 limitation. I think that at a minimum, Congress should ask for more detailed information about these people—who is going to get cut off; what size operations are they? They are not just big, million-dollar operations. These are, I would suspect, at least a fair number of these are what everybody in this room would probably consider a family farmer.

One of the reasons we have to keep in mind that these write-downs can be so low is because of the dramatic decline in land values during the 1980's. Some were recovered, but not back to the pre-1980's level.

In addition we need to recognize that some of this write-down is coming off of interest, and unfortunately during almost the entire decade of the 1980's, Farmers Home was not doing an adequate job of servicing. That's why Congress passed this act in 1987. And during that whole time, there was huge interest accruing on these loans that were not being serviced in a timely and reasonable fashion.

So we need to keep in mind that these are not necessarily, certainly, huge operations that went out and borrowed every penny they could get hold of; they are in fact, some of them, going to be family farmers, and due to circumstances, they need big write-downs—circumstances that they couldn't do anything about in most cases.

INCLUSION OF UNSECURED ASSETS IN DEBT RESTRUCTURING

The next proposal by the administration is to include the unsecured assets or assets that are not listed on security agreements or mortgages in the debt restructuring. This is an area which I think is the true loophole in the act, and if you take care of this loophole, you don't need to deal with one-time write-downs and $250,000 limits—unless what you are saying with the $250,000 limit is you just want to get rid of those big guys; then make the limit a lot higher than that so you're not getting rid of the little guys along with them. If that's what you want to say, maybe it makes sense, but that's what you will be saying by doing it.

But the exclusion of the additional assets I think is the loophole in the act, and if you tighten that up you should be able to resolve most of the concerns that I am hearing expressed.

Senator CONRAD. Lynn, let me just intercede there. Would you support including Sox' assets in these calculations?

Ms. HAYES. Sure. I think they should be distributed across the entire FmHA borrower list. [Laughter.]

Mr. JOHNSON. It wouldn't save a single farmer.

Ms. HAYES. But there are two separate proposals from the Administration on this. One is including the nonsecurity assets, or assets that are not listed on security agreements, and the other is including assets which allegedly the farmer has disposed of without permission. Those are two separate issues.

When you look at this area, though, I think it is important to keep in mind it is not as simple to tighten this up as the administration proposal seems to indicate. And if you want to preserve the basic concept of the act, which is number one, we get a realistic look at what we are going to get if we foreclose and liquidate the property, and number two, we get a realistic look at what the farmer can pay. Now, we know we are probably developing those numbers too tight, and I would agree in that respect, particularly on the cash-flow side. But if you are going to preserve that, then there are certain kinds of assets, even though they are not secured, that should be excluded from the consideration.

Number one are essential assets, assets that are essential to the farming operation or the maintenance of the family. An example is maybe 80 acres or so that if they don't have that 80 acres, they don't have a functioning operation—I mean to take a look at those kinds of essential assets. Or essential assets to the extent that they are assets that are producing income that is essential to the family or the supported farming operations.

Now, in that regard, I think under the current law, including the current FmHA regulations, any asset that is producing income, the income is already or should be taken into account in the debt restructuring process. It is part of the calculation of what the farmer can afford to pay. So to the extent they are income-producing assets, that is already taken care of, and it is already taken into account.

Senator Conrad. Let me ask you this. For example, if somebody has a half-million dollar sugar pot that they got from a rich uncle—and I'm looking for an uncle like that myself—$500,000 over here, and it is earning $50,000 a year—is that included in the calculation?

Ms. Hayes. The income is certainly included. The value of the asset is not under the existing law. The income, however, would be.

Senator Conrad. Sox.

Mr. Johnson. If we know it; if we know it is included.

Senator Conrad. That's another part of the problem. Let me ask you this. Is a big part of the problem here that we don't know that they have this asset?

Mr. Johnson. In some instances, that's correct.

Senator Conrad. Because it is outside of any of the documentation that is in front of you.

Mr. Johnson. That's correct, because it would relate to the extent they have financial statements and provide them to us and what they provide on those statements—as well as what we have knowledge and can inquire. But that is an inquiring process very much so with many of these stressed family farm operators.

Ms. Hayes. That is true, although we do have to recognize that there are several provisions of the law that encourage complete financial disclosures, and farmers can be prosecuted for not doing that, obviously. And it is a requirement, effectively, of the act that they include complete financial information.

So essential assets should be excluded, or as a minimum, if the income is there it should be included on the income side of the equation.

The other types of assets that are nonsecurity assets that should not be included are those assets where, at least to the value of a prior lien, a lien that would be prior to Farmers Home. The reason that should not be included in the debt restructuring process is because Farmers Home would never collect against that portion of the asset if they foreclosed and liquidated because the prior lienholder has first claim on that property. So you automatically exclude those.

You also should exclude assets that would be exempt from judgment creditors or exempt in a bankruptcy action, particularly with regard to judgment creditors. What would be a good example—well, a homestead that for some reason Farmers Home does not have a security interest in—Farmers Home would not be able to collect against that homestead in States with homestead exemptions because what they would have to do is foreclose on the farmland that they do hold a security interest in, collect what they can from there, and then go get a deficiency judgment. Many, many States would prohibit them from attaching that homestead.

So those kinds of assets should be excluded from the calculation of the net recovery value.

All of these things—the essential assets, the judgment creditors, the bankruptcies—are already excluded in various FmHA regulations. It is nothing new to Farmers Home to recognize these should be excluded. They are already in longstanding regulations on debt settlement and loan servicing.

So I raise these things because I think this is the true loophole. I think the real irritating factor here for a lot of people in the public perception factor is those people who are getting a windfall at the cost of the taxpayers. The loophole that needs to be filled up is figuring out why are we not taking into account those assets that are truly available if Farmers Home foreclosed into the debt restructuring process, and how you go about doing that. But I think it is absolutely imperative that we just not say "all nonsecurity assets"; that we look at it realistically, because if you don't look at it realistically, what you are going to get is a skewed balance on the net recovery value versus the present value of the restructured loan.

If you don't look at the assets Farmers Home could really get, you overestimate those assets, you are going to go for foreclosure and force that farmer off the land even though you're really not going to collect that. So I think we need to take a realistic approach so we don't destroy the balance of the equation that is built into the act. But the inclusion of additional assets I think is where the true loophole in the act is, and it needs to be tightened—but tightened in an artfully drafted way.

GOOD FAITH DEALING

The Administration also has proposed including good faith eligibility criteria for both the net recovery buyout and the preservation loan servicing programs, the farmland leaseback and homestead protection programs.

I think the important thing to keep in mind here is that if this is done, I think Congress needs to take the step of telling Farmers Home what they really want here. They should not just say good faith dealing. That can be construed too broadly, and I think even under the existing FmHA regulations it is construed too broadly.

When we hear of discussions on this issue, we generally hear about conversion, falsification of financial statements and those kinds of things. If that is what Congress wants to get at, and if Congress wants to deny farmers net recovery value buyouts and preservation loan servicing because of conversion and because of fraudulent financial statements, let's say that, and let's say it in detail, so that we don't pull in all the other, minor things that could be interpreted as bad faith.

One thing that I think, particularly with the conversion aspect, is always troubling when people talk of conversion is when farmers may have sold crops or livestock production and used the proceeds to pay for what was truly essential living and operating expenses, but in some cases they may not have had FmHA's prior approval, I think that because the statute now, and for at least all of the 1980's, Farmers Home has effectively been required by law to release production income for payment of essential living and operating expenses, we should look at the end result, the ultimate effect—did they really use it for living and operating expenses. And if so, let's not try to call that conversion even though there wasn't the formal permission there, if in fact it was used in that mechanism that they were required by law to release for anyway. Let's not be denying people these benefits on a technicality. Let's do it where there really was some fault and some misbehavior on the part of the farmer.

With regard to falsification of documents I think it is important to not just say any misstatement on a financial record or something, but to show that there was some evidence of intent that Farmers Home can demonstrate, or that there was some evidence of intent that the borrower fraudulently falsified those documents, in other words, he intended to benefit from the misrepresentation in some way that he otherwise would not be eligible for.

Now, I know that Farmers Home has repeatedly argued that they cannot prove intent. Well, all I am suggesting is some evident of intent. And it is not difficult to come up with—for example, if somebody had 500 acres free and clear that they simply forgot to list on their financial statement as compared to somebody having a small cash value in a life insurance policy or something. There is evidence that the bigger the problem, there is evidence of intent.

I think it is also important to note that FmHA's existing good faith eligibility criteria indicate that FmHA also believes that you can demonstrate some evidence of intent of a farmer's action. For good faith, they require demonstration of sincerity and honesty in meeting your agreement. Clearly, they are trying to get at the intent of the borrower there. So I think that if the intention is to get at truly bad people, or who we would all expect to be bad, let's say that in detail. And I don't think you can just leave a good faith dealing there. I think you need to define it so that it gets to only those people you really intend to. Otherwise what you're going to pick up are things like—if you simply have language that says "failed to meet your written agreement"—well, nonpayment of real estate taxes when due is a violation of your written agreements with Farmers Home, no matter whether you paid them a week later, or 2 weeks later, or are now prepared to bring them up current. That is a violation, and that effectively could be considered bad faith. So I think that it is very important to give tight definitions, and I think that Congress should take that action to give Farmers Home the kind of guidance they need on that.

SALE OF FMHA INVENTORY LAND AT MARKET VALUE RATHER THAN PRODUCTIVE VALUE

The next issue is the sale of inventory farm land at market value rather than the productive value, and again——

Senator CONRAD. Let me just interject and say we now need to move to conclusion of this hearing. It is 5 minutes to noon, and we have two more witnesses. So whatever you can do to expedite your final points would be helpful.

Ms. HAYES. OK.

I think that on the sale of inventory farmland at market value rather than productive value, the main point we want to make there is I think under the 1985 act that required the productive value, there was some intention to do that, to at least ensure that FmHA was not encouraging inflated land values that were occurring in the late seventies and so forth with their inventory land. And I think that limiting it to market value will in fact price farmers out of the land market, at least the FmHA land inventory.

If they can't pay for the land by farming that land, they can't afford to buy that land. So that the end result is that beginning farmers, minority farmers, or people who are trying to get the land back through the preservation loan servicing program will be priced out.

There may be a compromise; there may be some way that you could give them the option to buy it at the productive value, if they turned around and sold it within a certain period of time that they would have to pay the additional proceeds to Farmers Home, or something along that line.

CHANGE OF THE NET RECOVERY RECAPTURE AGREEMENT TO AN APPRECIATION FORFEITURE AGREEMENT

The next issue is the changing of the net recovery recapture agreement to an appreciation forfeiture agreement, in other words, to make the 2-year recapture agreement similar to the shared appreciation agreement.

I think there are a couple of things to keep in mind. If they are exactly the same, they don't really make a lot of sense. With the shared appreciation agreement, the borrower is still a borrower of the FmHA, so to the extent that there are some inclusions in that, because they are continuing to be financed by the FmHA, those don't apply on the recapture end of it.

The other thing to keep in mind is that if you extend it to 10 years, you will be encouraging bankruptcy filings again. People will be able to get pretty much the same thing for a bankruptcy court, but they are not going to have that 10 years hanging out there in which Farmers Home will be able to collect any appreciated value on the farmland.

The other thing that it does is it discourages any improvement, or in some cases maintenance, of the farmland and the buildings because the farmers will be afraid that they will be paying twice for those improvements. At the end of the 10-year period if it kicks in, they will be paying for that improvement again by paying for the appreciated value of the land. If there is an automatic kick-in like there is with the share appreciation agreement, you are going to effectively be punishing farmers who buy this land back at net recovery value who want to stay in farming. They are either going to have to sell the farm to pay for the appreciated value, or they are going to have to borrow against it to pay off Farmers Home. And there is going to be a real disincentive if that is the instance.

CONCLUSION

With that, I will close my comments. I just want to encourage the committee to look very carefully at what the implications of these proposed amendments really are on both the budget and on the public policy purposes implemented by the act and to not make any revisions at least to the extent that there is a complete understanding of what the ramifications are. And I think there is a need for some additional budget projections before there is a real good handle on what the implications may be to the taxpayers of some of these provisions.

Thank you.

[The prepared statement and attachment of Ms. Hayes follow:]

TESTIMONY OF
LYNN A. HAYES
ATTORNEY
FARMERS' LEGAL ACTION GROUP, INC.
BEFORE THE
SUBCOMMITTEE ON
AGRICULTURAL CREDIT OF THE
SENATE COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY
MARCH 5, 1990

Thank you, Mr. Chairman and Members of the Committee. I appreciate the opportunity to testify today regarding FmHA's implementation of the Agricultural Credit Act of 1987.

My name is Lynn A. Hayes. I am an attorney and the litigation coordinator for Farmers' Legal Action Group, Inc. (FLAG). FLAG is a nonprofit law firm representing farmers and ranchers around the country. The attorneys on our staff have been actively involved in FmHA issues for the past six years. Jim Massey and I represented a national class of approximately 230,000 FmHA farmer program borrowers in the Coleman v. Lyng lawsuit against the FmHA. That lawsuit effectively prevented FmHA from foreclosing or liquidating farmer program borrowers for most of the time between 1984 and the passage of the Agricultural Credit Act of 1987 because the court found that the methods employed by FmHA were illegal. FLAG has also represented FmHA farmer program borrowers in several other class action lawsuits. Congress addressed many of the issues raised in this litigation through the passage of the Agricultural Credit Act of 1987.

FLAG staff also travel all over the country speaking at training sessions for farmers, ranchers, and their advocates and lawyers. These events have been sponsored locally by 88 different organizations; some are national farm groups, some are church or legal organizations, and some are local, grass roots organizations. Total attendance at these gatherings has been 12,743; of these, 8,158 have been farmers, 2,706 lawyers, 1,228 advocates, and 651 a mix of public officials and interested citizens. At these training seminars, we have received a great deal of information about how FmHA is implementing its programs in various parts of the country.

In addition to the training seminars, we receive information about FmHA's activities from farmers, ranchers, and their lawyers and advocates through the hundreds of telephone calls we receive. We provide backup support and advice and analysis for attorneys and advocates representing farmers around the country.

Our organization also provides legal education materials which are available to farmers and ranchers and their lawyers and advocates. The materials we have produced that relate to FmHA are four editions of Farmers' Guide to FmHA; the Farm Survival Handbook and its accompanying VHS video tape; and a series of articles in our bimonthly newsletter, Farmers' Legal Action

Report, including the "Special Report" on the Agricultural Credit Act of 1987.

INTRODUCTION

When considering whether there is a need to revise the Farmers Home Administration provisions of the Agricultural Credit Act of 1987 (hereinafter the "1987 Act"), it is imperative that the public policy reasons for the enactment of that Act be kept in mind and maintained.

In my testimony, I will address:

1) The congressionally-expressed public policy justification for the enactment of the 1987 Act;
2) How the FmHA provisions of the 1987 Act carry out those public policies; and
3) The implications of the Administration's proposed revisions of the 1987 Act on:
    a) The furtherance of the public policies of the 1987 Act;
    b) Family farmers; and
    c) The federal budget.

THE PUBLIC POLICY PURPOSES OF THE 1987 ACT

In enacting the 1987 Act, both the Senate and the House expressed a continuing strong commitment to the preservation of family farms in this country. They did so at a time when economic pressures were presenting a very real and severe threat to the survivability of many of our nation's family farms. However, because of fiscal constraints, the 1987 Act was designed to ensure that the efforts to preserve these family farms were accomplished without undue burdens on the taxpayers. Ultimately, the FmHA debt restructuring provisions of the 1987 Act were designed to ensure that FmHA would not be forcing family farmers off their land when it would cost the government less to restructure and keep them there than to collect on the loans through the foreclosure and liquidation process.

A few quotes from the Senate and House Reports on the 1987 Act clearly establish that the Act was intended to further two goals: (1) to help preserve the family farm, and (2) to ensure that FmHA serviced farmer loans in a fiscally responsible manner.

> Under . . . [the new debt restructuring] program, the Secretary will restructure loans if the net return to the government is equal to, or greater than, the net return to the government through foreclosure . . . FmHA currently incurs huge losses in borrower bankruptcies and liquidations . . . Loan losses could be reduced by restructuring loans to a level the borrower can cash flow and make loan payments.

Sen. Rep. No. 100-230 to accompany S. 1665 (Nov. 20, 1987) 100th Cong., 1st Sess., at 45.

> Loan restructuring as envisioned in H.R. 3030 could include rescheduling, reamortization, renewal, deferral of principal, or interest monetary concessions, or other action regarding an outstanding loan, that would make it probable that the borrower's operation would become financially viable. *The purpose of this required restructuring purely and simply is to keep the farmer in business so long as that can be accomplished as cheaply as foreclosing the loan.* If properly done on appropriate cases, the circumstances can be very positive. The borrower remains on the farm in a viable operation where he can continue in his chosen profession and avoid the agony of losing the way of life enjoyed by the farm family. The institution, while it may take a financial loss, will not lose any more than if it had foreclosed the loan under which circumstance it would likely acquire property that would be a financial drain, disrupt the lives of the borrower and his family, and add to the tensions in the rural community.

H.R. Rep. No. 295(I), 100th Cong., 1st Sess., *reprinted in* 1987 U.S. Code Cong. & Admin. News (emphasis added).

The Senate Report sums up the congressional justification for the FmHA provisions of the 1987 Act:

> Debt restructuring will stop the unnecessary displacement of family farmers and generate earnings for FmHA. It will prevent FmHA from forcing farm families off of their land where that will cost the government more than allowing them to farm that land.

Sen. Rep. No. 100-230 to accompany S. 1665, (Nov. 20, 1987) 100th Cong., 1st Sess., at 45 (emphasis added).

The 1987 Act provisions were not designed to respond only to the economic crisis faced by many family farms in the 1980s. The FmHA provisions were designed, rather, to remain equally viable and effective into the future--to function appropriately in economic climates both favorable and unfavorable to family farm agriculture. This long-term goal was expressed in the House Report as follows:

> H.R. 3030, however, is not a bill designed simply to mitigate today's problems. It looks to the future--to an agricultural delivery system that not only will have dealt sensitively with today's financially-stressed farm borrowers but one that will be more competitive, more efficient, and more responsive to economic realities. It will have new safeguards that should help the Nation's agriculture industry to avoid future situations similar to current circumstances.

H.R. Rep. No. 295(I), 100th Cong., 1st Sess.

HOW THE 1987 ACT EFFECTUATES THE PUBLIC POLICY PURPOSES

The 1987 Act provided FmHA with a detailed formula that is to be used to determine whether the government will collect more from restructuring a farmer's debt than by foreclosing and liquidating the farming operation. FmHA has developed a computer program called DALR$ to perform these required calculations to ensure that all farmers are treated equitably. The 1987 Act requires FmHA to take whatever action is least costly to the government. DALR$ does this by computing two numbers required by the Act: (1) the present value of the restructured loan; and (2) the net recovery value of the collateral property. 7 C.F.R. Part 1951, Subpart S, Exhibit J.

To compute the present value of the restructured loan, DALR$ examines the farmer's budget and calculates the highest payments which the farmer could make to FmHA. DALR$ tries writing-down the farmer's loan to that level and then calculates the present value of the restructured stream of payments. The resulting figure--the present value of the restructured loan--is the amount of money which FmHA would receive if the farmer paid as much as he or she could pay.

To compute the net recovery value of the collateral, FmHA starts with a current appraisal of all of the property securing the loan. That number is entered into DALR$, and the computer then subtracts from that number all of the transaction costs of a forced liquidation or foreclosure (e.g., attorney's fees, fees for property management, resale fees, etc.). The resulting figure is the amount of money which FmHA would receive if FmHA acquired the collateral through forced liquidation or foreclosure. The initial decision about whether to restructure a farmer's debt, then, is based on the numbers.

If DALR$ indicates that FmHA will receive more money by restructuring than by foreclosing, FmHA performs a second level of analysis. This second level analysis is also required by the 1987 Act. At that level, employees of the FmHA county offices evaluate whether the borrower has acted in good faith, whether the borrower's problems have been caused by reasons beyond his or her control and whether the borrower has committed any kind of non-monetary default of his or her loan or mortgage contracts. 7 C.F.R. § 1951.909(c) and (d) and 7 C.F.R. Part 1951, Subpart S, Exhibit A, Attachment 3 (Appendix pages 39 and 72). If the borrower meets all of these criteria, and his or her "numbers work," then FmHA must offer to restructure the borrower's debt. If the borrower does not meet these criteria, and/or the borrower's numbers do not "work," the borrower is not offered restructuring.

If the borrower is denied restructuring, the borrower is offered a chance to buy out the loan for cash at the net recovery value--the value FmHA would receive if it collected on the loan by foreclosing and reselling. This program is called a "net recovery value buyout".

When administered properly, the beauty of the 1987 Act's debt restructuring program is that it maximizes the agency's ability to preserve small family farms while allowing the agency to pick the government's (and therefore the taxpayers') very best financial option.

The 1987 Act does allow borrowers who receive some debt write-down in the restructuring process to later be considered for restructuring if they become delinquent. However, such restructuring will only be granted a second time if the government would still receive more on the loan by restructuring than by collecting on the loan through the foreclosure and liquidation process.

ANALYSIS OF INDIVIDUAL PROPOSED REVISIONS TO THE 1987 ACT

It is important to analyze each of the proposed revisions to the 1987 Act to determine (1) whether it will further or undermine the public policy purposes of the 1987 Act, and (2) the budget implications of such action. To the extent possible, when the proposed revision undermines the public policy purpose of the 1987 Act or will cost the government additional money, I have indicated the types of amendments to the proposed revision that could correct or diminish these adverse effects. There has not been sufficient information gathered and reported by FmHA to adequately analyze or determine the budget implications of many of the proposed revisions. I believe that it is imperative to gather such information before making these major revisions to the Act.

One-Time Write-Down

One of the Administration's proposed revisions is to permit FmHA grant a borrower a write-down only once. Such a revision will significantly undermine the public policy purposes of the 1987 Act and will also cost the government significantly more money than maintaining the current provisions of the Act.

Making the decision to place a one-time limit on write-downs says that Congress has decided that it is worth spending taxpayers' money to force farmers off their land. Such a provision not only undermines the congressionally-stated public policy purpose of the 1987 Act, it exemplifies policy decisions that are the exact opposite of those exemplified by that Act. Rather than keeping family farmers on their land through restructuring as long it would cost no more to do so than to foreclose, the one-time write-down provision effectively says that even though the farmer will pay more on his note to FmHA with a second write-down than FmHA would acquire through a foreclosure action, the second write-down must be denied. This denial opens the way to foreclosure by FmHA.

To understand why a one-time write-down limit will not only force family farmers off their land but will also cost the government money, one must understand how the existing debt restructuring provisions work. Under the existing law, farmers can never obtain a write-down, whether it be a first write-down or a second, unless they will be paying FmHA as much or more than FmHA would receive if it collected the loan through foreclosure. The write-down will not always be to the level of the net recovery value. FmHA will write down debts only to the level necessary for the farmer to show that he or she has adequate cash flow to make a payment on the debt. The Act was designed so that the farmer will never be paying less to FmHA than FmHA could expect to recover through foreclosure action. Even with a second write-down, many farmers will still be paying FmHA more than it can expect to collect through foreclosure on the loan.

Thus, for every farmer who, even with a second write-down, could afford to pay FmHA more than it can expect to receive from a foreclosure action, there will be an additional financial loss to the government by denying the second write-down. In addition, when the program is properly administered, even if the farmer cannot afford to pay on a loan with a present value any higher than the net recovery value, the denial of a second write-down simply makes the statement that the government is willing to allow family farmers to be forced off their land even though it does not save any money for the federal government.

Since the need for a second write-down will only occur if the farmer does not have sufficient cash flow ability to make the existing FmHA debt payment, the denial of the second write-down ensures that he will not be able to cure the default. The next step for FmHA is to begin foreclosure proceedings. In many of these cases, the farmer's last chance to save the farm will be through the filing of a bankruptcy action. One of the stated reasons for enacting the debt restructuring provisions of the 1987 Act was to prevent the time and expense incurred by the government in just such unnecessary bankruptcy filings. This purpose of the enactment of the Act will also be lost with the one-time write-down limitation.

In order to maintain the long-term viability and integrity of the 1987 Act and the public policies it serves, the one-time write-down limitation should not be included. If, however, the Act is to be amended by a one-time write-down restriction, any such revision should at a minimum include specific exceptions. Such exceptions should be designed to recognize that limiting borrowers to a one-time write-down may force many farmers off the land at considerable expense to the federal government. Because of this result, application of the one-time limitation should apply only in those cases in which the need for the write-down was caused by factors truly outside the control of the farmer. If such exceptions are not included, farmers will be punished by the loss of their land due to circumstances the farmer could not have prevented.

Any one-time write-down amendment, at a minimum, should authorize FmHA to make additional write-downs if the farmer's need for the additional write-down is caused by one or more of the following factors:

1) A decline in agricultural land values in the borrower's county; and

2) Income and expense projections used to calculate previous write-downs have not been met due to:

    a) Commodity price projections FmHA required the borrower to use when calculating the net present value of the restructured loan that were higher than the actual prices received by the borrower;

    b) Livestock and/or crop production loss due to a natural disaster, an outbreak of uncontrollable disease, and/or uncontrollable insect damage;

    c) Reduction in essential income from a non-farm job due to unemployment or under-employment of the borrower-operator or spouse caused by circumstances beyond the borrower's or spouse's control;

    d) Illness, injury, or death of an individual borrower, stock holder, or partner who operates the farm; and

e) Economic factors that are widespread and not limited to an individual case that reduced the repayment ability of the borrower so that the scheduled payments cannot be made.

$250,000 Limitation on Write-Downs

Another of the Administration's proposed amendments to the FmHA provisions of the 1987 Act is to impose a $250,000 limitation on the amount of write-down or write-off a single borrower can receive. Such a $250,000 limitation would undermine the public policies exemplified in the 1987 Act in the same as the one-time write-down would.

When considering the $250,000 limitation on write-downs, it is important to remember that such a limitation does not simply mean that a farmer who would qualify for a larger write-down under existing provisions would just not get the additional benefit of that larger write-down--it means that the farmer would very likely lose the farm. This is true because under current law the farmer would only be eligible for a write-down over $250,000 if he could not afford to pay on the restructured loan unless more than $250,000 is written down. Since the farmer cannot afford to make the scheduled payments without the larger write-down, he or she will not be able to cure the delinquency on the loan and FmHA will continue with foreclosure proceedings. The $250,000 write-down limitation will effectively force farmers off their land, and it will do so at an additional cost to the taxpayers.

The $250,000 limitation, like the one-time write-down limitation, will cause the government to incur more financial losses than allowing larger write-downs under the existing law. For every farmer who could afford to pay on a restructured loan with a value equal to or greater than the net recovery value, even though such restructuring would involve a larger-than-$250,000 write-down, the government will lose more by limiting the write-down and foreclosing on the farmer than by giving the farmer the larger write-down. The budget impact of such a provision is likely to be quite significant. At a minimum, Congress should gather sufficient data from FmHA to accurately project the budget implications of these provisions before enacting such significant revisions to the 1987 Act. Accurate budget projections are especially important because the $250,000 limitation will be amending a provision of the 1987 Act that the 1987 budget projections indicated would not cost the government anything.

Like the one-time write-down, the $250,000 limitation will not only undermine the public policies exemplified in the 1987 Act but will implement policy decisions that are contrary to them. Instead of encouraging preservation of family farms as long as there is no additional cost to the government, the $250,000 limitation will act to displace family farmers at a considerable additional expense to taxpayers.

In considering such a dramatic public policy shift, it is also important to note that farmers' need for write-downs larger than $250,000 is not due in general to bad management or other failures of the individual farmers. These farmers in general have done nothing wrong. Their only failure has been to farm with FmHA loans during the 1980s when the values of their land and property securing such loans declined dramatically and they had to deal with an agency that refused to take reasonable actions to service their loans in a timely fashion. FmHA's failure to properly service farmers' loans as property values declined caused huge accumulations of interest as farmers waited nearly an entire decade to obtain some sort of reasonable loan servicing from the agency.

FmHA is likely to argue that the Coleman court injunctions prohibited it from servicing farmers loans during much of the 1980s. As the attorney who represented the farmers in that case, I can assure you that that is untrue. In fact, the Coleman injunction did just the opposite. The court orders required servicing of farmers' debts before the agency could foreclose and liquidate their operations. Instead of taking reasonable actions to comply with these court orders, FmHA fought the case every step of the way. Its actions continued to delay effective servicing of farmers' accounts until Congress finally took action through the 1987 Act to mandate the specific procedures FmHA was to use to service their delinquent debts.

A one-time write-down limitation or limiting write-downs to $250,000 punishes farmers not only for the effects of the agricultural crisis of the 1980s but also for FmHA's refusal to properly administer its farm loan programs.

Because of the cost to the government and the dramatic shift in policy that a $250,000 limitation on write-downs would precipitate, we recommend that no such revision be enacted.

Inclusion of Unsecured Assets In Debt Restructuring

The Administration has also proposed that when calculating the borrower's eligibility for debt restructuring, FmHA should consider all assets, even those that are not listed on the farmer's security agreements or mortgage documents. The issue of which assets will be considered in the debt restructuring and net recovery value calculations is very complicated. However, there may be some room to amend the asset provisions of the 1987 Act and still maintain public policies of the 1987 Act and at the same time prevent windfalls to farmers at the expense of the American taxpayers. Amendment to the asset provisions of the 1987 Act, if the integrity and long-term viability of the 1987 Act is to be maintained, is not as simple as the Administration's proposal implies.

One of the goals of the debt restructuring provisions of the 1987 Act is to ensure that when FmHA restructures loans, it does so in a way that projects the amount it could reasonably expect to collect if it foreclosed and liquidated the farmer's loan accounts. This is done by calculating the net recovery value--the value of the property securing the FmHA loans minus all of the expenses that FmHA would incur if it foreclosed and resold that property. This net recovery value figure is then compared to the present value of the stream of payments a farmer can afford to make to FmHA. The amount the farmer can afford to pay is based on the farmer's income and expense projections made on his or her Farm and Home Plan. The farmer is eligible for debt restructuring only if he or she can afford to make scheduled payments on a restructured loan with a present value equal to or greater than the net recovery value. The provisions of the 1987 Act that establish these formulas are designed to ensure that FmHA takes a realistic look at both what it would recover on the loan through restructuring and what it would recover on the loan through foreclosure. To ensure that the formula FmHA uses provides a realistic projection of the amount FmHA could realistically expect to collect, there must be a thorough analysis of which of the farmer's assets will be available to FmHA.

Including certain types of assets in the debt restructuring formula gives an unrealistic projection of what FmHA would collect if it foreclosed and got a deficiency judgment against nonsecurity assets.

To the extent that nonsecurity assets are essential to the support of the farm family or the maintenance of the farming operation, either because the asset is used in the operation or because it is producing essential income, the value of the asset should not be considered in the debt restructuring process. Considering the value of the asset would mean that the farmer had to sell the asset. If the asset is essential to the family's support or the maintenance of the farming operation, expecting the farmer to sell it would give FmHA an unrealistic picture of the farmer's ability to continue supporting his or her family and operating the farm. However, the income from any nonsecurity asset that is essential to the support of the family and the maintenance of the farming operation should be included in debt restructuring consideration. It should be included in the farmer's income and expense projections that are used to determine how large a loan payment he or she can afford to make. FmHA's current debt restructuring regulations already require that this income from nonsecurity assets must be included in debt restructuring consideration. No amendment to the 1987 Act is necessary to accomplish this.

FmHA has long had loan servicing and debt settlement regulations in place that acknowledge the essential property exception to the general rule that all assets must be considered when servicing or settling a farmer's debt.

> The County Supervisor must determine whether the borrower owns any assets which do not contribute to essential family living expenses or to the maintenance of a sound farming operation. The County Supervisor must determine whether the borrower could sell those assets and, if so, for how much. The County Supervisor will then prepare new cash flow projection which take into account the sale of the assets. If a positive cash flow projection can be achieved, the borrower is not eligible for a special set-aside. . . .

7 C.F.R. § 1951.41(d)(2) (Jan. 1, 1989).

Another regulatory reference indicating that FmHA recognizes that essential property should be excluded from servicing considerations is found in the debt settlement regulations.

> It is recognized that debtors must retain a reasonable equity in essential nonsecurity property in order to continue normal operations and meet family living. . . .

7 C.F.R. § 1956.66(a)(6) (Jan. 1, 1989).

Previous FmHA regulations have also acknowledged that when the agency considers nonpledged assets in settlement situations, it must take into account the liens of third parties on those assets.

> The value of the debtor's assets in relation to debts and liens of third parties is important in determining the debtor's ability to pay. . . .

7 C.F.R. § 1956.66(a)(6) (Jan. 1, 1989).

In addition, if FmHA chose to collect the debt through foreclosure and deficiency judgment action, it would not be able to collect from the value of nonsecurity assets (1) on which a non-FmHA creditor holds an existing lien or (2) that are exempt from judgment creditors under state law or are exempt in a bankruptcy action.

Since FmHA has already determined through the rule-making process that the value of nonsecurity assets should only be included in servicing and settlement calculations to the extent that:

a) The asset does not provide income to pay essential family living expenses or to maintain a sound farming operation,
b) There is no lien on the asset to another creditor,
c) The asset is not exempt from levy and execution by judgment creditors,
d) The asset is not reasonable equity in the homestead,

any amendment regarding inclusion of nonsecurity assets in the debt restructuring process should include all of these exceptions.

Including these exceptions will also serve to ensure that the formulas for calculating the net recovery value and the present value of the restructured loan contained in the 1987 Act give FmHA accurate projections of what it can reasonably expect to collect through foreclosure or through restructuring. On the other hand, if these exceptions are not included in any amendment that permits consideration of nonsecurity assets, FmHA will be forced to deny restructuring to farmers due to unrealistic projections of what it could collect by foreclosure and liquidation. To the extent that these projections are unrealistic and that FmHA would be forced to collect through foreclosure and liquidation rather than restructuring the loan, there would again be additional financial losses to the federal government. FmHA would be making a decision to deny restructuring even though it would actually collect more through restructuring than through foreclosure.

Good Faith Dealing

The Administration also proposes to amend the FmHA provisions of the 1987 Act by requiring "good faith dealing" as an eligibility criterion for both the net recovery value buyout and preservation loan servicing--farmland leaseback/buyback and homestead protection--programs.

There seems to be strong political pressure to amend the Act to include such "good faith dealing" criteria for all of the loan servicing programs. The discussions regarding the need for the "good faith dealing" eligibility criteria all appear to be based on allegations that farmers have converted security property or have fraudulently falsified information or documents provided to FmHA. Presumably, then, such an amendment to the Act is intended to punish those farmers by denying them the benefits of the net recovery value buyout or preservation loan servicing programs. In discussing this proposed amendment, it is important to keep in mind that there is already in existence a mechanism to punish those people who convert property or falsify documents. FmHA can bring civil or criminal actions against these farmers for the alleged legal deeds. These proceedings include all the protections of the judicial system, which are designed to ensure that only truly guilty people are punished.

If, rather than taking advantage of the built-in protections in the judicial system, Congress chooses to deal with conversion and falsification of documents through the FmHA administrative process, it is extremely important to include a sufficiently detailed description of what "good faith dealing" means to Congress. This is the only way to ensure that only the farmers who Congress believes should be denied the benefits of the Act will in fact be so denied.

Simply allowing FmHA to draft its own definition of "good faith dealing" is likely to cause denials of servicing benefits to farmers whom Congress does not intend to deny. FmHA's current definition of "good faith" for purposes of the debt restructuring eligibility provides the best example of how this may occur. FmHA regulations provide:

> The borrower has acted in good faith by demonstrating sincerity and honesty in meeting agreements set forth on Form FmHA 1962-1, "Agreement for the Use of Proceeds/Release of Chattel Security," and agreements made with FmHA. Any allegations of fraud, waste, and conversion used in order to deny borrowers' requests for Primary Loan Service Programs will be substantiated by FmHA, with a written legal opinion from the Office of General Counsel, before denying the borrower's request for such programs.

7 C.F.R. § 1951.909(c)(2).

This definition allows FmHA to deny borrowers debt restructuring for any failure to meet agreements, no matter how minor an infraction. The following are points to keep in mind when structuring a sufficiently detailed definition of good faith.

1) Any "good faith" definition that requires compliance with all "written agreements" would include any provision in the form promissory notes, security agreements, and mortgages that the borrowers have signed. Technically, under such a definition, the failure to make a scheduled payment to FmHA would be a failure to comply with the written agreement with the Secretary. Obviously, Congress does not intend this to be considered bad faith, since all of the debt

restructuring language is based on the fact that the borrowers are unable to make their payments.

2) In addition, any failure to make a real estate tax payment or an insurance payment WHEN DUE would be a violation of written agreements with the Secretary. Even if the borrower later made the payments or is now prepared to bring these up to date, it is still a violation of a written agreement. Unfortunately, in many instances borrowers have been unable to pay their real estate taxes or their property insurance when due because FmHA would not release proceeds from the sale of crops, livestock, or livestock products in order for the borrower to make these payments. For example, even when we were directly involved in the negotiations, the attorneys for FmHA flatly refused to release proceeds from the sale of crops so that our client could pay his property taxes. Their position was that the state could not do anything to them for seven years for failure to pay real estate taxes and, therefore, it was not necessary to make those payments. There are all kinds of minor provisions contained in security agreements and real estate mortgages or other FmHA forms with which a borrower may not have completely complied, many times to no fault of the borrower but rather to FmHA's actions.

3) It should also be noted that FmHA has often failed to comply with its written agreements with the borrowers. For example, the same security agreements required FmHA to make additional loans to borrowers when the borrowers were eligible for those loans. The form agreements with FmHA also require FmHA to comply with its statutory and regulatory requirements. FmHA has repeatedly violated its own regulatory requirements. This is particularly true when it has failed to release proceeds from the sale of normal income security so that the borrower can pay essential living and operating expenses, or when FmHA has failed to provide the borrowers the opportunity to appeal adverse decisions.

Many of the farmers' failures to comply with every word of a written agreement with FmHA may have been due to representations made by the FmHA county employee.

Often, such representations or oral agreements are not appropriately documented in the FmHA file.

4) Any definition of "good faith" should also make it clear that if a farmer sold normal income security--crops or livestock production--and used the proceeds for essential living and operating expenses, he or she should not be denied loan servicing for failure to act in "good faith". This should apply even though FmHA does not have documentation in the file indicating specific authorization for the transaction.

   FmHA has for years been required by law to release crop and livestock production income for payment of essential family living and farm operating expenses. Through the 1970s, this requirement was contained in the FmHA regulations; as of 1984, it was incorporated into court orders in the Coleman case; and in 1985 and again in 1987, Congress mandated such releases by statute. Since the release of essential living and operating expenses is required by statute, the fact that FmHA's files do not document prior approval should not be used against the farmer if the proceeds from the sale were actually used for such expenses. Often, the lack of FmHA documentation is due to county employee failure to record information in the files or to request that the farmer complete the FmHA forms that are to be used to document such transactions.

   Since the issue is really the ultimate use of the production income, if the income was properly use for essential living and operating expenses, the farmer should not be considered to have acted in "bad faith".

5) Any definition of "good faith" that includes falsification of documents should make it clear that there must be some evidence which demonstrates that the falsification was done with the intent to defraud the government. An inadvertent oversight in the listing of numbers on forms submitted by the farmer should not be cause to deny loan servicing benefits if there is no evidence that the farmer intended to gain something that he would not otherwise be eligible to obtain.

   Some evidence of intent is not difficult to produce. For example, if the misrepresentation made by the

> farmer was large and he stood to benefit significantly from it, there is some evidence of intent. In its current definition of "good faith", FmHA makes it clear that even it believes that it is possible to demonstrate factually what a borrower is intending by his actions. FmHA's regulations require a demonstration of "sincerity and honesty", which is effectively a demonstration of what the farmer intended by his actions.

Any amendment to the 1987 Act requiring a farmer to have acted in "good faith" in order to receive benefits should be drafted in sufficient detail to take into account all of the issues discussed here and ensure that FmHA will not be denying services to borrowers whom Congress did not intend to be denied.

Sale of FmHA Inventory Land at Market Value Rather Than Productive Value

The Administration is concerned that farmers whose land is near industrial developments, suburban expansions, or other fast-appreciating areas could gain a windfall profit at the government's expense under the current law. Under the present law, FmHA must sell its suitable inventory property to farmers at a price that reflects the productive value of the land. The concern is that a farmer could convey his or her land to FmHA, buy it back at a very low "productive" value, and then turn around and sell it at a great profit for a non-agricultural use. The Administration's proposal addresses that concern by requiring that all land be sold out of inventory at its appraised market value.

The Administration's proposal throws the baby out with the bath water. The original congressional reasoning behind the "productive value" sales price was to keep agricultural land in agricultural use. Congress passed the productive values sales law to address exactly this situation: it did not want agricultural land to be sold at a price that was too high for farmers to pay. If the debt load on the land is more than could be serviced by agricultural production, farmers are effectively priced out of the market. Therefore, the proposal the Administration has before Congress today attempts to directly dismantle the action Congress deliberately and intentionally implemented in the Food Security Act of 1985.

A compromise position could effectively address Congress's concern without undermining the goals of the 1985 Act. That compromise could involve an appreciation forfeiture agreement. The agreement would allow a farmer to choose to purchase land at a productive value rather than market value, but it would provide that if the farmer were to sell the land within a specified time period, all of the profit would go to the government. In this compromise, the farmer would have an ironclad incentive to keep the land in agricultural production; and if the farmer sold the land within the specified time period, the government would realize all of its profit.

Change of Net Recovery Value Buyout Recapture Agreement to a Appreciation Forfeiture Agreement

Another of the Administration's proposals is to change the two-year net recovery buyout recapture agreement to a ten-year appreciation forfeiture agreement.

Such a revision would frustrate one the goals of the 1987 Act. When considering this provision, it should be noted that in enacting the Agricultural Credit Act of 1987, Congress intended to diminish the number of unnecessary Chapter 12 and other bankruptcy filings. Congress heard testimony which indicated that in many cases the sole reason for a bankruptcy filing was due to FmHA's failure to work with its borrowers. One of the purposes of the debt restructuring provisions of the 1987 Act was to give FmHA the tools to effectively work with borrowers rather than force borrowers to file bankruptcy actions in order to have their loans restructured. By extending the recapture period to ten years, Congress would effectively again be encouraging bankruptcy filings. This ten-year period effectively gives FmHA the ability to come back in and increase what it would be able to recover against the property for up to ten years. Normally, in a Chapter 12 bankruptcy, what FmHA can recovery will be determined when a plan is confirmed. FmHA will certainly not be able to require payments on a debt based on the appreciation value for more than the three to five years of the Chapter 12 plan. Thus, many borrowers who would otherwise be offered net recovery value buyout under the current law would likely opt to file bankruptcy if this provision of the law is changed.

If the Administration's proposal is to change the recapture agreement language to be consistent with the debt restructuring shared appreciation language of the Act, there are many reasons why it should be rejected. First, once a net recovery value buyout occurs, the farmer no longer has a loan with FmHA. Therefore, the provisions in the shared appreciation agreement that deal with ceasing of farming should not be of a concern at that stage, since the farmer is no longer an FmHA borrower.

Second, if the shared appreciation agreement also applied to a net recovery value buyout, it would automatically kick in at the end of the ten years. This could effectively force farmers to sell their land or be foreclosed on by FmHA simply because land values had increased over the ten-year period and the borrower could not afford to pay that increase in value. This punishes farmers who want to remain in farming. In the debt write-down provisions, FmHA has dealt with this by making arrangements for reamortizing the loan if the borrower is found by FmHA to be unable to pay the recapture amount under the shared appreciation agreement. This would be impossible to do with the net recovery value buyouts, since the farmer no longer has a loan with FmHA.

Third, in the attempt to tie the net recovery value buyout recapture amount to the appreciated value of the land, it discourages any reinvestment or upkeep of the farming operation. It simply encourages farmers to let property run down rather than improve it for fear that they will effectively be paying for the improvements twice once the shared appreciation agreement kicks in.

For these reasons, we do not believe that the two-year recapture agreement should be changed to a ten-year shared appreciation agreement or appreciation forfeiture agreement.

When considering amendments to the FmHA provisions of the 1987 Act, we ask that Congress not take any action until sufficient information is gathered to make accurate projections on the budget impact of the proposed revisions. We also ask that any such amendments be skillfully drafted to ensure that the long-term viability and public policy purposes of the 1987 Act are not undermined.

FmHA Implementation of the Agricultural Credit Act of 1987

Rather than repeating extensive testimony that has already been presented to this Committee regarding problems with FmHA's implementation of the Agricultural Credit Act of 1987, I simply refer you to a lengthy letter James T. Massey and I sent to Senator Kent Conrad that which was incorporated as Mr. Massey's written testimony at a May 9, 1989 hearing of this subcommittee.

Respectfully submitted,

Lynn A. Hayes

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LAH/acp
Attachments

Effects of the Administration's Proposed Amendments to the FmHA Provisions of the 1987 Ag Credit Act

One-Time Write-Down Limitation

- Costs the government (taxpayers') money
- Contrary to the public policy purposes of the 1987 Act
- Forces family farmers off their farms

$250,000 Limitation On Write-Downs

- Costs the government (taxpayers') money
- Contrary to the public policy purposes of the 1987 Act
- Forces family farmers off their farms

Consideration of Additional Assets in Debt Restructuring

- Without proper exclusions, creates unrealistic projections that cause unnecessary farm foreclosures

"Good Faith" Eligibility Requirement

- Without detailed definition, unfairly forces farmers off land

Sale of Inventory Farmland at Market Value

- Prices farmers out of farmland market
- Discourages young, beginning, and minority farmers from acquiring land

Change Recapture Agreement to Appreciation Forfeiture Agreement

- Frustrates purpose of the 1987 Act by encouraging bankruptcy filings
- Punishes farmers who want to remain in farming
- Discourages proper care and improvement of farmland and buildings

Senator CONRAD. Thank you very much.

Before we let this panel go, I wanted to ask Sox and the FmHA, at the February 20 hearing on guaranteed loans, you said you would consider sending notices to guaranteed lenders of the loan servicing programs authorized by the act. I wanted to know if you have had a chance to——

Mr. JOHNSON. We are in the process.

Senator CONRAD. You are in the process of doing that. Could you get a draft of that to us—we would certainly appreciate that—prior to issuing it, so we would have a chance to comment?

Mr. JOHNSON. Sure. We'd be happy to.

Senator CONRAD. And would you agree to send notices to guaranteed lenders whenever these lenders notify FmHA that a loan is delinquent? Would that make sense?

Mr. JOHNSON. You are talking about a general one, which is what we're going to send out now.

Senator CONRAD. Right, a general one.

Mr. JOHNSON. Again, we are not talking about a 50-page instrument. We are talking about a 1- or 2-page reminder.

Senator CONRAD. Right.

Mr. JOHNSON. But certainly, I think we could put that in our regulations to require that the county offices——

Senator CONRAD. It would seem to make sense. Then we'd have everybody in an informational sense onboard.

Mr. JOHNSON. Surely.

Senator CONRAD. All right.

I want to thank this panel very much. It has been excellent testimony and very helpful.

Next, we are going to hear from Randolph Nodland, president of the National Family Farm Coalition, and Mr. Don Schieber, a farmer from Ponca City, Oklahoma.

Welcome. It is good to have you both here. If you would proceed with your testimony, first Mr. Nodland, and then Mr. Schieber, that would be very helpful to the committee.

Mr. Nodland.

STATEMENT OF RANDOLPH NODLAND, PRESIDENT, NATIONAL FAMILY FARM COALITION, DUNN CENTER, ND

Mr. NODLAND. Thank you, Senator Conrad. We appreciate this opportunity to appear before this subcommittee.

INTRODUCTION

As you said, my name is Randolph Nodland. I am a grain and livestock producer in southwestern North Dakota. I currently serve as president of the National Family Farm Coalition, which I will refer to as NFFC. We appreciate the work that this subcommittee has done to monitor the implementation of the Agricultural Credit Act and to consider amendments to the act as Congress debates the 1990 farm bill. The Credit Committee of the NFFC has been working very hard to bring the concerns of our member groups to you.

Credit policy is important, but farm income to pay current bills, service debt, and revitalize our rural communities is essential. The NFFC supports change in Federal farm policy that will ensure that farmers receive a price for their commodities at a level that covers our costs of production through increased loan rates.

I'd like to add a side comment. Many farmers are going to receive a "double whammy" if the administration's farm bill proposals succeed. On one hand, Agriculture Secretary Yeutter is saying to farmers, "We cannot raise your farm support prices. You have to produce for the world market." On the other hand he is saying to the same people, "We are going to tighten up on credit by limiting eligibility and limiting write-downs," a the same time farm production costs are going up.

North Dakota State University recently completed a cost production analysis for several commodities. They project that in 1990 in western North Dakota, for instance, a wheat producer will lose $1.16 an acre for every acre of wheat produced. On Durum wheat, that same producer will lose $15.60 an acre based on the target price and normal yields. It certainly appears that we are on the fast track to eliminate the family farm. We have lost over 400,000 farmers in the United States and over 6,000 in North Dakota alone since 1985.

The USDA proposals in the farm bill Green Book and the House Agriculture Committee action last week are of major concern. It seems that some Members of Congress have forgotten why they passed the Agricultural Credit Act of 1987 and its purposes. FmHA has already lost over $8 billion, and the Agricultural Credit Act was an attempt to reduce further losses by either the Government or farmers across the country. These provisions were to provide a cost-effective alternative to bankruptcy.

The $250,000 limit of write-downs or write-offs passed by the House Agriculture Committee contradicts the least cost alternative basis of the Agricultural Credit Act. We also question whether this will be an increased cost to taxpayers since those farmers whose debt exceeds the $250,000 cap will probably have no alternative but to file bankruptcy or face foreclosure.

FMHA NOTICES

On FmHA notices, for many of the 80,000 FmHA borrowers who have received their FmHA notices over the past year, the process is far from over. According to FmHA in January, only 9,500 borrowers had obtained a write-off or a write-down under the act. There were over 40,000 borrower accounts still unresolved.

I am going to skip some of my testimony and touch on some of the high points.

FMHA APPEALS

On the FmHA appeals, the good news for farmers across the country is that the National Appeals Staff has been reversing nearly 50 percent of the cases. The bad news is that many State FmHA directors are refusing to follow the decisions. The high reversal rates illustrate farmers' concerns of continued misapplication of the statute and regulations. We are concerned that FmHA may be using their latest appeal regulations to overturn favorable appeals decisions. This threatens the independence of the national appeals process.

LAND IN INVENTORY

The ability of family farmers to repurchase land out of the FmHA inventory has remained a major concern. There have been problems with previous owners receiving adequate notice about their rights as well as the definition of who can actually repurchase the land. We have heard reports that security agreements for previous owners to purchase the property are too high. The 1987 Agricultural Credit Act established targeted participation rates for repurchase of land out of inventory by socially disadvantaged individuals. We strongly support this program yet are concerned by reports that specific parcels of land that may not be very desirable are being set aside for this program.

H.R. 4077 and the USDA proposals to remove the productive capacity of the land calculation raises major concerns about the commitment to the priority considerations for purchase and retaining land in farming. We question how many family farmers are going to have the opportunity to repurchase their land out of the inventory when they are competing with the appraised market value for their property. We are concerned that this change guts the targeted participation rates for repurchase of land in the inventory by socially disadvantaged individuals. Current law has resulted in only 22 properties being sold under the criteria. This situation must be closely monitored.

CONSERVATION EASEMENTS

On conservation easements, the present policy of allowing the Fish and Wildlife Service to determine easements to be attached to the deed for land in inventory raises major concerns. We support a change in the law that would cover FmHA inventory land being repurchased or leased by the previous owner. They should have the option of conservation easement *unless* the easement is on land that covers existing wetlands which have not been used as crop or pasture land in the previous 5 years, and cannot in a typical production year be used without a man-made drainage system.

The land must be reappraised after the easement has been granted and prior to the reoffer of the land to the previous owner to accurately reflect the decrease in the value of the property.

The day before I came out here last week, I had a call from a farmer in central North Dakota who is repurchasing his land back from FmHA, 1,600 acres, and he asked me to relay his concern. Three hundred acres of the 1,600 has an easement attached to it. U.S. Fish and Wildlife had determined that this land could not be used for any purpose except grazing. This is land in and around fields that he is farming that cannot be used for anything except livestock. He had always hayed this land, put up hay on it, and now he can't use it for anything but grazing. It is not fenced. It is in areas where you would have to just fence little patches out. They are not offering any significant reduction in appraisals on the land—he said about $20 an acre is what they are offering to reduce the cost of that land, which for land in that area, I would suspect it would be worth $250 or $300 an acre. So it is pretty insignificant for land that you can't really use for anything if you can't graze it. If it is in an area that you can't graze, it is worthless. And this is land that seldom has water on it except in a real wet year, early in the spring; it does at times have a little bit of water on it.

So he asked me to relay those concerns, and I can give you his name if you wish to have it.

Senator CONRAD. Well, I'll tell you, I have heard this so many times from so many different people that it was the basis for my question earlier on conservation easements. Clearly this is having more significant effect than many anticipated, and somehow we have to address it.

Thank you very much.

MEDIATION

Mr. NODLAND. I have one more comment. The key to making the restructuring process work is mediation. There is a growing need for consistent treatment with regard to mediation in all States. This past year, 14 States received Federal matching funds for State mediation programs. There is a continued need for new and expanded mediation programs to work through the restructuring process. We have urged the House and Senate Appropriations Subcommittees to fund mediation at the full authorized level of $7.5 million to meet this increasing need, yet the level is still at $3.5 million, and with the projected 43 percent drop in net farm income that is being projected, there is going to be a real need, I think, for mediation in the future.

Thank you.

[The prepared statement of Mr. Nodland follows:]

National Family Farm Coalition

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TESTIMONY OF RANDOLPH NODLAND,

PRESIDENT
NATIONAL FAMILY FARM COALITION
BEFORE THE

SENATE AGRICULTURAL CREDIT SUBCOMMITTEE

MARCH 5, 1990

My name is Randolph Nodland. I am a grain and livestock producer in S.W. North Dakota. I currently serve as President of the National Family Farm Coalition (NFFC). We appreciate the work that this Subcommittee has done to monitor the implementation of the Agricultural Credit Act and to consider amendments to the Act as Congress debates the 1990 Farm Bill. The Credit Committee of the NFFC has been working very hard to bring the concerns of our member groups to you.

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The USDA proposals in the Farm Bill Green Book and the House Agriculture Committee action last week are of major concern. It seems that some Members of Congress have forgotten why they passed the Agricultural Credit Act of 1987 and its purpose. FmHA had already lost the over $8 billion and the Agricultural Credit Act was an attempt to reduce further losses by either the government or farmers across the country. These provisions were to provide a cost-effective alternative to bankruptcy.

The $250,000 limit of write-downs or write-offs passed by the House Agriculture Committee contradicts the least cost alternative basis of the AG Credit Act. We also question whether this will be an increased cost to taxpayers since those farmers whose debt exceeds the $250,000 cap will probably have no alternative but to file bankruptcy or face foreclosure.

FmHA Notices

For many of the 80,000 FmHA borrowers who received their FmHA notices over the past year, the process is far from over. According to FmHA in January, only 9,500 borrowers had obtained a write-off or write-down under the Act. There were over 40,000 borrower accounts still unresolved. Some farmers have been offered net recovery buyouts but cannot secure the financing. Many farmers received 1099 IRS tax forms telling them they have had large incomes based on their 1989 write-offs or write-downs yet have no income to pay these IRS debts. We are concerned that FmHA in their pursuit of changing the Ag Credit Act borrowers' rights provisions are forgetting that the Federal Treasury will be recovering some of these funds in IRS payments and others in shared appreciation agreements during the next 10 years. FmHA is using some examples of large write-downs to discredit the entire program. In many cases, the problem lies in FmHA mismanagement of their Emergency loan programs not in the FmHA ownership and operating loans.

DEBT RESTRUCTURING:

We remain concerned about the DALR$ program. There have been problems with FmHA employees changing the numbers from a farmers' submitted Farm and Home Plan. We are also concerned that FmHA's use of their 5 year projections, not the farmer's past record, for commodity prices creates a barrier for farmers who want to diversify their farming operations. Problems with implementation has required unnecessary appeals that is costing everyone scarces resources as well as preventing farmers from making changes in their farming practices.

The USDA and H.R. 4077 proposal to limit a farmer to one write-down ignores the possible need for a second write-down due to circumstances beyond a farmers' control. Current law only triggers a second write-down if a borrowers' collateral drops or if the first write-down did not take a borrower down to the value of the collateral.

Proposals to include all assets in the restructuring and buyout calculations need to exclude those assets that are excluded under bankruptcy provisions. There should also be an exclusion for essential operating equipment and land. Without these exclusions the farmer would not be able to continue operating. The farmer should be able to appeal any disputes about their assets in the security agreement.

Net Recovery Buyouts:

The high number of net recovery buyout options and low number of debt restructurings is no surprise based on FmHA's commodity projections. While thousands of these net recovery offers are just offers since there is no financing available, FmHA and H.R. 4077 would extend the net recapture agreement for these buyouts to 10 years. We are concerned that this length of time will act as a disincentive for a farmer to make necessary improvements since they could lose any increased value if they had to sell. We support extending the recapture period to 3-5 years to be consistent with bankruptcy provisions. Otherwise it would not be the least cost alternative for the farmer or the government. The recapture should not be triggered if the transfer is to an immediate family member.

FMHA APPEALS -

The good news for farmers around the country is that the National Appeals staff has been reversing nearly 50% of the cases. The bad news is that many state FmHA Directors are refusing to follow the decisions. The high reversal rates illustrate farmers' concerns of continued misapplication of the statute and regulations. We are concerned that FmHA may be using their latest appeal regulations to overturn favorable appeals decisions. This threatens the independence of the National Appeals Process.

FmHA must be instructed to be as timely as possible in the appeals so as not to starve farmers out by their delays. We have heard reports of long delays with appeals now scheduled for mid-March which is the middle of planting season. Appeals should not be used when a meeting could have achieved necessary modifications to make the plan work.

FmHA employees acting in "bad faith" should not be costing farmers their economic livelihood nor taxpayers scarce resources. It shouldn't require a National Appeals Review and hundreds of hours in between by the farmer, their attorney or an advocate, and FmHA to resolve relatively simple issues.

FmHA COUNTY COMMITTEES -

The 1987 Ag Credit Act outlines important new responsibilities and duties of County Committee members. In many cases, the law and the regulations have not been adequately explained, and consequently, committee members have made judgements which have severely impaired the ability of farmers to implement necessary management decisions which will make and keep their farm businesses viable. Extensive local training of County Committee members must be a priority.

County Committees need to understand that they are to look at the operation and when possible and cheaper for the government to keep working with that farmer. They need to be aware of the potential FmHA loss in bankruptcy and foreclosure if the debt restructuring is not successful.

County Committee members must also deal with the problems facing those who left farming during the past 10 years on the advice of FmHA county supervisors. These people were told to liquidate their farms and turn over the proceeds to FmHA in satisfaction of debt. They did so in good faith and are now often struggling off the farm in new jobs. The understanding was that FmHA would go through with debt settlement and forgive deficiencies as promised. This was not done for various reasons and now these people are facing a financial consequence which they should not have. County Committees should see that such debt settlement is accomplished and that deficiencies are erased as FmHA implied that they would be when these former operators complied voluntarily with FmHA's request.

There continue to be problems with County Committee elections. The nomination, voting and appointment procedures must be clearly defined and conducted in a fair and equitable manner.

LAND IN INVENTORY

The ability of family farmers to repurchase land out of FmHA inventory has remained a major concern. There have been problems with previous owners receiving adequate notice about their rights as well as the definition of who can actually repurchase the land. We have heard reports that security requirements for previous owners to purchase the property are too high. In some cases farmers are being told they must mortgage their homestead to buy the land. The 1987 Agricultural Credit Act established targetted participation rates for repurchase of land out of inventory by socially disadvantaged individuals. We strongly support this program yet are concerned by reports that specific parcels of land that may not be very desirable are being set aside for this program.

H.R. 4077 and USDA proposals to remove the productive capacity of the land calculation raises major concerns about the commitment to the priority considerations for purchase and retaining land in farming. We question how many family farmers are going to have the opportunity to repurchase their land out of inventory when they are competing with the appraised market value for their property. We are concerned that this change guts the targetted participation rate for repurchase of land in inventory by socially disadvantaged individuals. Current law has resulted in only 22 properties being sold under the criteria. This situation must be closely monitored.

The gap between capitalization value and appraised market value is the greatest in farming regions that are close to industrial, suburban, or coastal development. FmHA characterizes capitalization value, as "giving the buyer a windfall at taxpayers' expense." We support a change in the current law that would preserve and create opportunities for entry and re-entry farmers. We support a recapture agreement for land repurchased at capitalization value. With the exception of transfers within the immediate family, a 100% recapture of the difference between the capitalization value and the sale price would trigger on any sales within five years.

CONSERVATION EASEMENTS

The present policy of allowing the Fish and Wildlife Service to determine easements to be attached to the deed for land in inventory raises major concerns. We support a change in the law that would cover FmHA inventory land being repurchased or leased by the previous owner. They should have the option of the conservation easement unless the easement is on land that covers existing wetlands which have not been used as crop or pasture land the previous five years, and cannot in a typical production year be used without a man-made drainage system.

The land must be reppraised after the easement has been granted and prior to the re-offer of the land to the previous owner to accurately reflect the decrease in the value of the property.

APPRAISALS

The appraisal affects the options for the farmer today as well as future payments to FmHA through shared appreciation, net recapture agreements or tax liability. The right and the timing of appealing appraisals must be clarified to avoid unnecessary delays and expense. Appraisals must be fair and in line with the productive capacity of the land and comparable to the area. They should be done using independent appraisers who do not work for FmHA.

Land must be reappraised to reflect any easements that may have been placed on the land while in FmHA inventory. Unless reappraised at FmHA expense, the farmer is paying for land whose value has been significantly altered.

MEDIATION

The key to making the restructuring process work is mediation. There is a growing need for consistent treatment with regard to mediation in all states. This past year 14 states received federal matching funds for state mediation programs. There is a continuing need for new and expanded mediation programs to work through the restructuring process. We have urged the House and Senate Appropriations Subcommittee to fund mediation at the full authorized level of $7.5 million to meet this increasing need yet the level is still at $3.5 million.

We support reauthorization of the state mediation programs. In states where there is not a state certified program, the law should specify the role of mediation to ensure that farmers are receiving appropriate mediation services.

CONCLUSION

On behalf of the Coalition, I thank the Subcommittee for hearing our concerns. For nearly a decade, many of our farmers have been working to keep the family farm system a viable segment of the Agriculture industry during this current crisis. We appreciate your leadership and look forward to working with you this Spring to develop the 1990 Farm bill.

Senator **Conrad**. Well, I couldn't agree with you more. I think that mediation money is some of the best money we spend. Everywhere I have gone, people have told me that that is the case. Not only farmers have told me that, but bankers have told me that they have found the mediation process to be an effective one and a very healthy process in terms of helping people work through these problems.

Mr. **Nodland**. One other thing, when we are getting cost figures, benefits—one other figure I think we need is as to what the benefit of the shared appreciation will be to the process down the road. I think that is another issue that I did not hear discussed today—maybe it was—but what the benefits of that would be.

Senator **Conrad**. That's a very good point. There was not much discussion of that, and clearly that has to be factored into the consideration of that here as well; a very good point.

Mr. Schieber.

STATEMENT OF DON SCHIEBER, FARMER, PONCA CITY, OK

Mr. **Schieber**. Mr. Chairman, I appreciate the opportunity to appear before you today.

INTRODUCTION

I would just like to submit my written testimony for the record and ask that you study it and look at it and carefully diagnose what I have said. I have jotted down some notes that I would like to just take some time to go through just in the essence of time.

Senator **Conrad**. Please do.

Mr. **Schieber**. The first thing I'd like to say is that I am a family wheat farmer. I have four children, and I live in north central Oklahoma.

Senator **Conrad**. Winter wheat?

Mr. **Schieber**. Hard Red Winter wheat, yes.

I WAS RESTRUCTURED BY THE FMHA LAST SPRING

I was restructured by the FmHA last spring. But now I am a taxpayer—the first time in 6 years that I have had to pay taxes.

The loan that got me in trouble was the EE loan, the Economic Emergency loan, that I took in 1984. And part of the reason I got into trouble because of that loan was because of the way the payback schedule was set up on those loans. Those were 7-year loans. I had a $98,000 loan. My first payment on that loan was $49,000. And with another crop disaster, I was in trouble from day one. There was just no way I could get out of it. And that's the reason the EE loans are in trouble is because of the way they are to be paid back. Fifty percent of your debt is to be paid the first year, and it just doesn't work.

When I went through the restructuring program—and I chose restructuring. I had another option; I could have taken bankruptcy. But I chose not to do that because in bankruptcy, I would have hurt all my small-town businesses that I deal with every day. I have credit with those people. I still have credit with those people. In bankruptcy, I wouldn't have. And think of what it would do to the small-town economy if myself and other farmers in my community would have done that.

But when I chose the restructuring possibility, I wanted to get it done as quick as I could so I'd know where I stood. Another thing is I feared that that thing might change. You never know what is going to happen any more.

I did not know what the DALR$ program was going to say because we put a bunch of numbers into a computer program, and we did not have any idea of what that thing was going to do with them or what it was going to say. I showed the packet at this committee a year ago, the restructuring packet that we had to fill out. I thought I had mine filled out correctly. Before my deadline to turn it in, I took it to some people who specialized in filling these things out. They had the DALR$ program. We ran it through the DALR$ program. I knew what was going to happen to me before FmHA did. And when we took the numbers to FmHA, we came out with a different answer in the same DALR$ program. I don't know why. The DALR$ program has been changed more than once since the program started, and if I run my numbers that I used last year through the DALR$ program now, it would be a different answer again.

I have signed a recapture agreement with FmHA for the amount that was forgiven on the debt that I had with them. I am still liable for that debt; it has just been delayed.

At the same time, the basis and everything I own, including my equipment and all my land, has been written down to zero. So if I ever sell my land or if I ever sell my equipment, my cost basis in that equipment is now zero, and I will be paying income tax on all of that. So the Government is still going to get that money back. Whether they get it in the form of taxes, or whether FmHA gets it in the form of a repayment to them, it is still going to be paid back. The tax liability if I sell my land is still going to be there. If I pass the land on to my children, they pass it on to their children, the basis is still going to follow that land wherever it goes.

Since the restructuring has happened to me, I have applied several times for short-term money because now I am solvent. I have been turned down twice for short-term money even though the numbers are there, the cash-flow is there, the collateral is there. The specific reason that both lending institutions gave me for turning down my loan was because I had a write-down.

My credit in this situation is the same as if I had taken bankruptcy. I don't have any credit. So the only credit that I have available to me now is a guaranteed loan, and that puts me right back in with FmHA. I'm in the process of filling that application out. After I get through today, I may not have that option. But I was able to obtain short-term money using my crop that I have planted now for collateral. But the only way I could do that was with a cosigner. I was able to find two cosigners that had a combined net worth of $1 million to back up a $60,000 loan that I had $80,000 of collateral for. It doesn't make sense to me. And at the time we closed the loan, the lending officer of the bank told me that just because he is now making me this loan, and he might have been in trouble if he didn't make it with that kind of a backup on it, that it did not mean that we were beginning a long-term relationship. So I may have to go through that whole thing again.

At the same time all of this is happening to me, I had another problem in that my bank was closed in the spring of 1987 because a lot of times when you go into banks now in north central Oklahoma, they don't want to talk to farmers. I had one bank tell me that the only farmer I am loaning money to is the one that doesn't need it; if he's got a CD in the bank, "Yes, we'll loan you all you want," because he can get his hands on that collateral right quick.

I don't know what the answer is. We can't tell a bank to make a guy a loan. I don't know what it is, what we're going to do about it.

I'd like to make a few comments about the county staff in the FmHA. My County Supervisor covers two counties. He's got 5 days in the workweek, 2 days in each county, and the fifth day wherever they need him the most. He doesn't have enough staff in the county to do the workload. He's got over $40 million of loans in his portfolio. They are expecting one person to cover that much loan. When you go into a bank, they've got 10 or 15 people covering less than that. I don't know how they can expect to do everything correctly with this kind of staffing.

I think these people are underpaid for what they have to do. My County Supervisor, when he takes vacation time, locks himself in his office, won't answer the phone, won't do anything, just to try to get caught up on his paperwork. He's got paper piled 2 feet high on his desk all the time. He shouldn't have to do that. We are going to lose people like that because they are going to suffer from burnout. They are going to get tired of the system.

I don't know why they can't simplify everything that they do. We've got so much paperwork anymore—why do they have to have 10 times as much paperwork for an FmHA loan as we do for a bank loan?

It seems now that some of the things we are seeing with the FmHA restructuring program, they have slowed down; it seems like they are waiting on this new law to be passed that is going to change everything and give you one write-down, limit it to $250,000 and this kind of thing, and they have slowed those things down and kind of stalled them out.

I think that changing the restructuring should be researched thoroughly before you consider any major changes.

At the time I was restructured, I was still insolvent, and some of the comments I heard earlier pointed out that that was a big problem. But I think at that point it is too early to tell what the actual condition of that farmer is. At the time I was restructured, I was insolvent. Today I'm not. But it allowed me to do some things that I could not do before I was restructured, such as get caught up with my short-term local creditors, my implement dealer, my co-op, my electric company, my fuel supplier, fertilizer suppliers—all these people. They stuck their necks out to stay with me, hoping that I could be restructured. They didn't have any choice because they knew what the alternative was; it was bankruptcy. And they knew where they stood if that happened.

So I think that we really need to give them a little bit of time to see what does happen after they have been restructured because then you can make a decision, and you can make a hard decision on whether the guy is really viable or not.

I don't look at restructuring as a giveaway program, and I think the public has a misconception about that. I am still liable for my debt whether it be tax debt or whether it be through the recapture agreement. All they have done is just change the way I look at it on my financial statement and change the way that they will get it back someday. So it is a whole complex issue, and I will not take any more of your time now, but just look at my written testimony, and if you have any questions I'll do my best to answer them.

[The prepared statement of Mr. Schieber follows:]

TESTIMONY OF DON SCHIEBER

OKLAHOMA FARMER

BEFORE THE SENATE AGRICULTURE SUBCOMMITTEE
ON AGRICULTURAL CREDIT

MARCH 5, 1990

Mr. Chairman, I appear before the Subcommittee today for the purpose of reporting the process and results of restructuring my farming business through the Agricultural Credit Act of 1987. I will review the personal progress made as result of restructuring my Farmers Home Administration loans, and inform this committee as to how the process has, and is working for other farmers in Oklahoma.

I am testifying today at the invitation of the Committee and appreciate the opportunity to share my personal experiences on the implementation of the Agricultural Credit Act of 1987 as it relates to the Farmers Home Administration.

My testimony will be directed to the Committee relative to how the Act was implemented in Oklahoma, the need for amendments to it, and a brief comment on Secretary Yeutter's proposed amendments to the Act.

Mr. Chairman, I appeared before this Subcommittee in January of 1989, just as I was beginning the restructuring process through Farmers Home Administration. I maintained a concern at that time for the farmer's need for technical information and support as to the criteria Farmers Home Administration used to judge the feasibility of my proposed plan of restructuring.

My prior concerns proved to have merit. The process of restructuring through Farmers Home Administration is unimaginatively technical & complicated. Before one can restructure he must be able to design a blueprint that will effectively repair the damages.

Without technical knowledge of the criteria used by FmHA to judge the feasibility of restructuring, many farmers have simply been "out-foxed" by a set of computer based decisions, that could have resulted in favorable decisions with only minor changes in the operation. Perhaps the single most important problem that I have encountered from other Oklahoma farmers is the absence of this "technical" information.

Fortunately, Mr. Chairman, I was able to gain access to that technical data, the DALR$ computer program, and technical training on FmHA rules prior to submitting my plan of restructuring. This type of educational approach resulted in my being able to arrive at a solution that has resulted in regaining viability to my farming business. In fact, I would consider the restructuring process to be the winning ticket for myself, FmHA, and the American taxpayer.

I. WINNING TICKET -- In the past several years my farming business has been unable to generate a profit, and in fact, has experienced substantial losses from two natural disasters. To cover these losses, I borrowed money through Farmers Home Administration's Emergency Loan Program anticipating being able to recover those losses through future year's production. Unfortunately, substantial increases in interest rates, low commodity prices, and the recent drought, rendered me helpless in being able to repay these loans. My *decision* to attempt restructuring under the Agricultural Credit Act was based upon my desire to remain in farming, pay my debts, and return my business to a taxpaying status. I am proud to inform this Committee today that all my objectives were met through restructuring.

A. *First, my farming business has regained viability*. For the first time in many years, I am able to pay my hometown creditors in full; and I would like to thank the rural town businesses for their support which allowed myself and hundreds of other farmers to remain in business at a time when Farmers Home Administration was unwilling to advance operating loans.

B. *Secondly, my farming business generated a taxable profit in 1989; the first time in six years.* My income tax returns for 1989 list an $18,000 tax debt which resulted from operational profits directly attributable to restructuring. Although, Mr. Chairman, some Americans may not understand why I am excited about owing that amount of taxes, I will assure you that I remember too well the days when my farming business was profitable, and incurred taxable income from those profits, and Mr. Chairman, I hope and pray this year's income tax return is a sign of return to those days.

C. Third, I have renewed my sense of pride in being among the ranks of taxpayers who shoulder the tax burden in this country. Being insolvent through the past several years gave me a sense of frustration that somehow I was being denied a basic obligation.

D. Fourth, I have saved the American taxpayer thousands of dollars through restructuring. As you recall, Mr. Chairman, I informed you of my decision to restructure through the Agricultural Credit Act of 1987. It was a decision selected from many alternatives which are available to all businesses. One of those alternatives is of course, bankruptcy. From a pure business prospective, bankruptcy would have perhaps afforded me a better deal in that, among other benefits, I would not remain obligated to Farmers Home Administration for the unsecured portion of my debt, and I would not have had the legal obligation to pay local hometown unsecured creditors in full.

With all the misconceptions and misinformation the public is receiving about farm debt restructuring I sincerely hope they are made aware that Restructuring is an option; one that is far more advantageous to them than other alternatives such as liquidation, or bankruptcy. Farmers are choosing this option because they want to pay their debts, and are willing to enter into legal obligations with the Government that will allow taxpayers the opportunity to recapture the debt write-down. Americans simply must realize that I am still obligated to the Government for the full amount of my indebtness. Restructuring has, however given me the opportunity to temporarily remove the portion of debt which was above the value of my assets, and begin making a profit.

The restructuring process also allows farmers to pay debts other than FmHA. Most of these debts were incurred as a result of home town business such as Co-op elevators, implement dealers, rural banks, rural electric companies, and other business sticking their necks out to stay with farmers during a time when the Government practically stopped lending through FmHA. To prevent complete chaos, these rural businesses have stepped in believing that their extension of credit would be paid through the process of restructuring. Hundreds of farmers in Oklahoma would not have growing crops as we speak, without the local creditors believing that the new law would allow them to be paid.

There is no doubt in my mind that farmers will be able to pay all their debts through restructuring; conversely, many of those who FmHA does not restructure will be unable to pay their creditors. This, by the way, will have a secondary effect on the American taxpayer and other farmers as well. FmHA's failure to find feasible plans through "restructuring" will force thousands of farmers to liquidate, and file bankruptcy. Businesses will be forced to take huge losses, and consequently, will pass that loss on to -- guess who? -- The American taxpayer as well as other farmers.

There are thousands of other farmers who are attempting to "restructure" under the Agricultural Credit Act. Because of the tremendous backlog of cases, many farmers are awaiting FmHA's decision. Most of these farmers will be able to accomplish the same objectives as I have if they are restructured. I hope Congress, and the American taxpayer support the restructuring of these loans.

Write-downs, covered by the Act have already been expensed to the taxpayers in the Fiscal Year that the loan was made. It is in the best interest of Congress, the USDA, and the public to act in a prudent and business manner by following a course of least cost. There are inherent risks in all phases of lending. All lenders calculate their least cost to solving debt problems. Many financial problems faced today by producers and FmHA have their origins, not in bad management decisions made by the producer or FmHA, but in Government playing spring rules; that is springing new rules, (policies) on producers in midstream.

These policy changes generally have had the effect of turning sound management decisions into a financial nightmare for the producers. For example, changing the rules on restructuring during midstream. Even if Congress chances making technical Amendments to the Agricultural Credit Act, it should not affect those now in the pipeline. These farmers have gone to great lengths to educate themselves, and prepare feasible plans. Changing the rules on them simply would be unfair.

As we consider the proposed changes to the Act, and begin debate on the new omnibus farm bill for 1990, we must not fail to address the maintenance of net farm income, or face a second round of crisis to farm credit.

II. NEED FOR TECHNICAL AMENDMENTS TO THE AGRICULTURAL CREDIT ACT.

It has come to my attention that Congress is considering a series of technical amendments to the Agricultural Credit Act through the introduction of HR 4077. Without commenting on each of those proposed changes I wish to go on the record of supporting the National Farmers Union, National Family Farm Coalition, Farmers Legal Action Group, and many other National organizations opposition to the Amendments as introduced.

Mr. Chairman, I do not feel with my testimony today showing the American public the undeniable fact that "restructuring" under the Agricultural Credit Act, affords them every possible opportunity to avoid losses, that any major revisions need to be made. I respectfully request that this Committee, and Congress, investigate the facts as to how restructuring has affected other farmers. I have been told by many farmers that they too have become solvent through "restructuring", and are now showing a net income tax on profits. Tampering with amendments that might affect farmers becoming taxpayers again could bestow grave consequences upon Rural America, and create enormous burden's upon the public.

Congress must not consider Amendments on the merit of political posturing, miscommunications, misinformation, or without consideration to the effects such Amendments may have on the positive results coming in from farmers who have been restructured. I hope that this Committee will obtain the dollar amount of "Shared Appreciable Mortgages" that have been placed on farmers which will recapture the so called debt write-down. I also hope that Congress will consider the large number of farmers who previously have not been able to generate taxable profits, that will become taxable through "restructuring" before altering legislation that is working! I sincerely believe it may be that "restructuring" results should be researched before considering any major alterations. These results will clearly show Congress, and the public that "Restructuring" under the Agricultural Credit Act affords everyone far greater advantages than any other alternative, and is not, in fact, a "give away" program to the farmer by any stretch of the imagination!

That concludes my statement, Mr. Chairman. I'd be happy to answer any questions that you and your colleagues may have.

Senator CONRAD. Thank you, Mr. Schieber.

I was very interested in your written testimony. You indicated that the restructuring was the most advantageous to the taxpayer of any of the options that were in front of you. Could you share with us why you believe that is the case? As you know, there has been a good deal of public reaction that we have not looked after the taxpayer's interest. You are asserting just the opposite. Maybe you could tell us why.

Mr. SCHIEBER. Well, for the indications that I made earlier. I have reduced the basis in all my property to zero. I am going to pay my debt back to the Government one way or another. It has not really been a giveaway to me. That's the main point that I really want to make is I haven't really been given that much. I have just changed the way that I am going to repay it.

Senator CONRAD. You are really making two points. The recapture agreement, and second, the tax effects. The two of those combined means that you are going to pay ultimately what came from the Federal Government.

Mr. SCHIEBER. This is true.

Senator CONRAD. And this restructuring has bought you some time and hopefully will allow you to succeed.

Mr. SCHIEBER. This is true. Another thing, with the basis in my equipment being reduced to zero, my equipment that I use is 10 years old now. I am fearful that we are going to go into the "rust age" on the farm machinery. What is this going to do to the people who make the farm machinery and all the jobs that are associated with that? If the farmers are not being able to purchase new equipment, to do a better job of food production for the people of this country and the world, for that matter, what is going to be the picture there?

Another point that I really want to make is that if we would have had decent farm prices back in 1984 and 1985, and from then through now in the projections I have seen through the first half of the 1990 decade, we wouldn't be talking about these kinds of things today.

Senator CONRAD. A very good point. Farm income would solve a lot of these problems. It is really central to the whole question that is before us. If you are going to have income, a lot of these questions become moot. Without income, we are going to be faced with continuing stress and pressure out in the farm community. And very frankly, with what has been proposed, it almost undermines what we have been able to do with the Agricultural Credit Act. If we are not able to find some way, some policy, that allows people to cover the cost of production plus some reasonable return, the future of agriculture in this country is seriously jeopardized.

Now we have the lowest cost of food in the history of mankind in this country. It does lead you to the conclusion that in fact it is not the farmer who is being subsidized; the program that we have is subsidizing the consumer in this country very effectively.

Mr. NODLAND. Senator, we have farm bill that will do that.

Senator CONRAD. Yes. All right.

Mr. SCHIEBER. I might make one final comment.

Senator CONRAD. Yes, sir.

Mr. **Schieber**. This past week, we had a lady from Australia visit our home and stay overnight. We went to a local restaurant, and she was looking at the menu, and her comment was: "Your food is so cheap here."

Senator **Conrad**. That's a comment we get from others as well. If you really want to get that comment, have somebody from Japan come and see what it costs to get a steak in a restaurant here. It is a fraction of what it would cost them just to buy the piece of meat and take it home and cook it.

So I am not certain that people understand fully what a remarkable deal we have as consumers in this country. If we don't do something to secure the base of agricultural production in America, we may learn to our chagrin what a wonderful deal we lost today.

This is an incredible challenge. I say to you that all of us who are from rural America and understand the pressure that rural America is under have an obligation to share that with the rest of the country and especially the opinion leaders who take that message to the public.

I have found a very disturbing thing occurring. In 1988 when we faced a drought, we had a pretty sympathetic audience. Then in 1989, the second year of drought, that audience had become not only unsympathetic, but in some cases, positively hostile. And I don't think these images of the rich farmer with the million-dollar write-down matches the reality that all of us see.

I would be very hopeful that those of us in rural America would share more fully and more effectively with those who are the opinion leaders what is really happening. I think it goes beyond those who cast a vote here in Congress. It goes to the editorial writers of The Washington Post and the New York Times and those who bring us our evening news broadcasts. We need for them to understand that there is a slow-motion economic strangulation occurring in the rural parts of this country. And if we don't address it and address it effectively, we will reap the harvest for the future. That will be a future that is diminished for all of the people in this country when the food production of America falls into the hands of just a few. Then we will see what the true food cost is.

So I hope all of those who are listening understand the extraordinary stress that is out across rural America. The testimony this morning demonstrates how deep it is and how enduring it is. If we don't find a way to address it, we will rue the day that we allowed the structure of family farm agriculture in America to fall by the wayside.

I want to thank these witnesses and all the others who have appeared here today. It has been an excellent hearing.

The subcommittee will stand in adjournment.

[Whereupon, at 12:30 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

[Material submitted for inclusion in the record follows:]

APPENDIX

NATIONAL FARMERS UNION,
March 5, 1990.

DEAR SENATOR: This morning while the Senate Agriculture Credit Subcommittee holds its hearing on the Farmers Home Administration as part of its 1990 farm bill deliberations, delegates to the 88th annual convention of the National Farmers Union meeting in Oklahoma City approved the attached special order of business dealing with FmHA policy.

Given the importance of the subject matter before the subcommittee, the Farmers Union convention delegates request that the NFU special order of business be made a part of the hearing record.

Respectfully yours,

LELAND SWENSON,
President.

SPECIAL ORDER OF BUSINESS

(Adopted by Delegates to the 88th Annual Convention, National Farmers Union, Oklahoma City, Oklahoma)

MARCH 4-7, 1990

National Farmers Union calls for the continuation of the "least cost policy" for the determination of Farmers Home Administration's loan servicing activities. We oppose the attempt to limit the eligibility of borrowers for this loan servicing activity.

The "least cost policy" was adopted by Congress because the Farm Credit System was willing to foreclose on some borrowers rather than write down the loan—even if the write-down would be less costly to the Farm Credit System. It was adapted to the FmHA because Congress felt that the Federal Government should apply the same standards to its agricultural lender that Congress required of the cooperative lending system.

The concept of keeping a producer on the farm if it was the least cost to the Government was a financially prudent idea in 1987 and it still is today. We oppose any attempt to amend the Agricultural Credit Act of 1987 to weaken this provision.

United States
Department of
Agriculture

Farmers
Home
Administration

Washington
D.C.
20250

JAN 26 1990

The Honorable Kent Conrad
Chairman, Subcommittee on
Agricultural Credit
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to your letter requesting information from the Farmers Home Administration (FmHA) in preparation for upcoming hearings on the Agricultural Credit Act of 1987 and the credit title of the 1990 farm bill.

In anticipation of this request, FmHA initiated a field survey in December to collect the necessary data. Excepting the information provided in question number two, all data is a result of the survey. The data is cumulative, covering all notices that have been sent since the implementation of the Agency's 1951-S loan servicing regulations through November 30, 1989. Because of this, some borrowers who may have been delinquent twice, are counted twice.

Your questions, with their answers are listed below:

1. How many bad faith determinations have been appealed by FmHA borrowers since the National Appeal Staff began its work?

298 Borrowers have appealed denial of loan servicing due to bad faith or an Office of General Counsel legal opinion.

How many appeals have resulted in the National Appeal Staff overturning these determinations or FmHA decisions based on these determinations?

42 decisions have been reversed by the FmHA National Appeals Staff.

How many appeals have resulted in the National Appeal Staff sustaining these determinations or FmHA decisions based on these determinations?

98 appeals have resulted in the initial decision being upheld.

How many of these appeals are still pending?

158 appeals remain unresolved.

FmHA Farmers Home Administration is an Equal Opportunity Lender.
Complaints of discrimination should be sent to:
Secretary of Agriculture, Washington, D.C. 20250

2. How many FmHA borrowers were finally convicted of conversion from 1980 until passage of the Agricultural Credit Act of 1987?

FmHA does not maintain centralized records on this subject. However, we were able to obtain the following information from the Department's Office of the Inspector General (OIG). Between 1980 and 1987, FmHA requested 2,502 OIG investigations for conversion and falsification. Of that number, OIG completed 1,213. During the same period, 348 borrowers were actually convicted, their cases being handled by the Department of Justice (DOJ). Of the 1,213 investigations completed, OIG does not maintain records on how many were actually referred to DOJ for prosecution.

This information does not necessarily provide a complete picture on this subject because OIG does not separate conversion from falsification in its records. Additionally, prior to agreeing to investigate and or prosecute, both OIG and DOJ must assess the strength of FmHA's case as well as determine whether or not such actions make sense relative to the Government's cost verses any potential recovery.

3. Please provide an update on the Farmer Program Servicing Activities report sent to my Subcommittee in April, which provided statistics on the:

number of Notices of Availability of Loan Servicing Programs sent:

75,352 Notices of Availability of Loan Servicing have been sent.

number of restructuring applications returned and not returned:

34,064 were returned and 41,288 were not returned.

number of delinquent borrowers who qualified for restructuring:

32,548 accounts were resolved, 19236 of which with Primary Loan Servicing.

still pending:

42,804 accounts are pending for a variety of reasons.

total amount of the write-downs and write-offs:

The Agency has completed $796,524,800 in write-downs and $1,034.334,726 in net recovery buy-out write-offs using its 1951-S authorities. Additionally, $933,115,392 has been written-off using debt settlement authorities.

number of applications that were not completed:

FmHA does not have a breakdown for this number.

number of borrowers who bought their accounts current or paid in full since receiving their notices:

4,493 have paid current and 1,424 paid in full.

Attached you will find a chart relative to the status of FmHA's loan servicing activity. Because of the complexity of individual accounts and the number of options available to borrowers throughout the process, the information shows the status of Resolved and Unresolved accounts.

4. Subtitle B, Sec. 711 of the Agricultural Credit Act of 1987, entitled Improvement of Secondary Market Operations for Loans Guaranteed by FmHA, requires the Secretary to issue final regulations within 180 days of enactment. It is my understanding that proposed regulations have been submitted to the Office of Management and Budget, which has expressed some concerns about them. What are OMB's concerns? How do you intend to address these concerns, and when will proposed regulations be issued for public comment?

Since the authorization of a Secondary Market, FmHA has worked diligently with the Office of Management and Budget and the Department of the Treasury in search of the best method of implementation. A number of issues have been raised. They range from whether or not the payment funds should be classified as "public monies," to the budgetary scoring of the market itself. The Agency has been working on innovative concepts to address these issues and hopes to come forward with a proposal in the near future.

5. When will final regulations implementing the Agricultural Credit Act be issued?

We expect to publish final regulations in May or June.

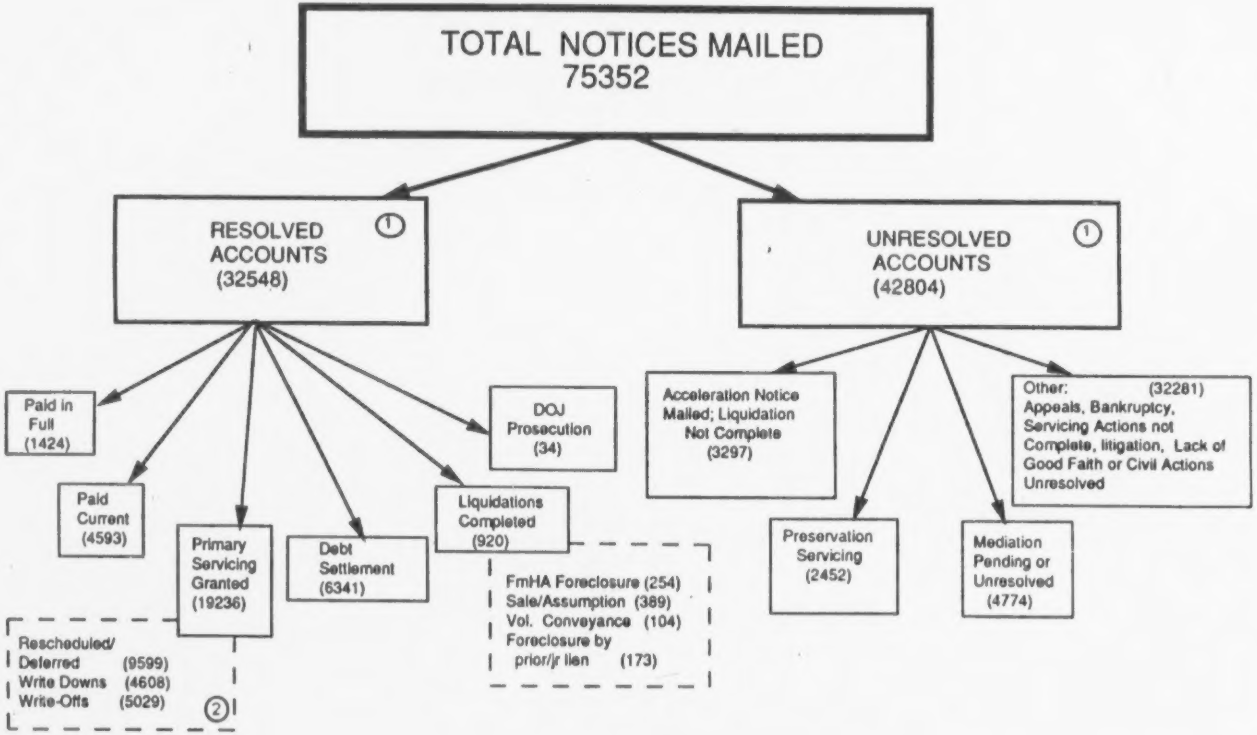
Sincerely,

NEAL SOX JOHNSON
Acting Administrator

Attachment

FmHA LOAN SERVICING ACTIVITY THRU 11/30/89

Agricultural Credit Act of 1987


TOTAL NOTICES MAILED
75352
RESOLVED ACCOUNTS (32548) ①
UNRESOLVED ACCOUNTS (42804) ①
Paid in Full (1424)
Paid Current (4593)
Primary Servicing Granted (19236)
Debt Settlement (6341)
Liquidations Completed (920)
DOJ Prosecution (34)
Rescheduled/ Deferred (9599)
Write Downs (4608)
Write-Offs (5029) ②
FmHA Foreclosure (254)
Sale/Assumption (389)
Vol. Conveyance (104)
Foreclosure by prior/jr lien (173)
Acceleration Notice Mailed; Liquidation Not Complete (3297)
Preservation Servicing (2452)
Mediation Pending or Unresolved (4774)
Other: (32281) Appeals, Bankruptcy, Servicing Actions not Complete, litigation, Lack of Good Faith or Civil Actions Unresolved

1. Includes Borrowers who failed to respond.
2. Write-Offs are Net Recovery Buyouts.

lbf:1/22/90

The Honorable Kent Conrad
Chairman, Subcommittee on
Agricultural Credit
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20510

MAR 2, 1990

Dear Mr. Chairman:

On behalf of Secretary Yeutter, this is in response to your letter of February 16, which requested a Farmers Home Administration (FmHA) legal opinion concerning "good faith" and information regarding the capitalization values of the Agency's inventory farm property.

Enclosed you will find a legal opinion from the Office of the General Counsel. The opinion states why the "good faith" provision used to determine borrower eligibility for primary loan servicing does not provide FmHA with the authority to deny primary loan servicing to a borrower unwilling to use other assets to bring a delinquency current.

You also requested the number of inventory farm properties with capitalization values which are 5-10 percent, 11-20 percent, or more below the appraised market value. Unfortunately, the information to make such a comparison is not available at the National Office level as it is a part of individual case files in each FmHA County Office. Obtaining the information would require an examination of each individual appraisal for the approximately 4,000 inventory properties. FmHA does not automate this kind of data.

We hope that this information will be helpful to you.

Sincerely,

NEAL SOX JOHNSON
Acting Administrator

DAVID L. BOREN OKLAHOMA
HOWELL HEFLIN ALABAMA
TOM HARKIN IOWA
KENT CONRAD NORTH DAKOTA
WYCHE FOWLER JR GEORGIA
THOMAS A. DASCHLE
SOUTH DAKOTA
MAX BAUCUS MONTANA
J ROBERT KERREY, NEBRASKA

ROBERT DOLE KANSAS
JESSE HELMS NORTH CAROLINA
THAD COCHRAN MISSISSIPPI
RUDY BOSCHWITZ MINNESOTA
MITCH McCONNELL KENTUCKY
CHRISTOPHER S. BOND
MISSOURI
PETE WILSON CALIFORNIA
SLADE GORTON WASHINGTON

United States Senate
COMMITTEE ON
AGRICULTURE, NUTRITION, AND FORESTRY
WASHINGTON, DC 20510-6000

February 16, 1990

JOE O'NEIL
TO: STEVE BABCOCK
JACK HERZFELD
NATHAN
SD #
2-26

The Honorable Clayton K. Yeutter
Secretary, U.S. Department of Agriculture
Room 200-A, Administration Building
Washington, DC 20250

Dear Mr. Secretary:

The Subcommittee on Agricultural Credit of the Senate Committee on Agriculture, Nutrition and Forestry will hold a hearing March 5 on the implementation of the Agricultural Credit Act of 1987 by the Farmers Home Administration.

I would like to invite the Acting Administrator, Neal Sox Johnson, to testify at the hearing. The purpose of the hearing is to review the status of implementation of the Act, and to discuss the need for amendments to it. For this discussion, I would appreciate a written legal opinion from your Office of General Counsel as to why the "good faith" provision used to determine borrower's eligibility for primary loan servicing does not provide FmHA with the authority to deny primary loan servicing to a borrower who is unwilling to use unsecured, nonessential assets to bring his delinquent loan current. I would also like to know how many FmHA properties currently in inventory have capitalization values which are: 5-10% below the appraised market value, 11-20% below the appraised market value, and more than 20% below the appraised market value. I would appreciate the inclusion of this information in Mr. Johnson's testimony.

NO.

The hearing will be held in 332 Senate Russell Office Building at 2:00 p.m. Witnesses are asked to send sixty copies of their written testimony no later than Friday, March 2. Please have testimony delivered to the Committee on Agriculture, Nutrition, and Forestry, in the 328A Senate Russell Office Building, to the attention of Mary Byrne.

I am looking forward to Mr. Johnson's testimony.

Sincerely,

Kent Conrad

KENT CONRAD
CHAIRMAN, SUBCOMMITTEE ON
AGRICULTURAL CREDIT

KC:wsd

United States
Department of
Agriculture

Office of the
General
Counsel

Washington,
D.C.
20250-1400

January 31, 1990

MEMORANDUM FOR NEAL SOX JOHNSON
ACTING ADMINISTRATOR
FARMERS HOME ADMINISTRATION

From: Stephen L. Babcock
Assistant General Counsel
Community Development Division

Stephen L Babcock

Subject: Net Recovery Buyout and Unencumbered Assets
Questions on Proposed Agricultural Credit Act
Amendments

In connection with hearings held January 25, 1990, by the Subcommittee on Conservation, Credit and Rural Development, House Committee on Agriculture, Chairman English has asked for the legal basis for this Division's advice to Farmers Home Administration on two questions. I am addressing this memorandum to you with the understanding that you may supply it to Chairman English and the members of his Subcommittee.

The first question is whether the agency can, under present law, also apply the "good faith" provision (that now applies to write-downs of loans) to net recovery buyouts.[1] The second question is whether the agency must ignore unencumbered assets owned by an applicant for a write-down when computing the amount of the write-down.

We are of the opinion that the agency cannot extend the "good faith" test, which is set out in paragraph (2) of subsection (b) of section 353 of the Consolidated Farm and Rural Development Act, to the net recovery buyout provision of that section, which is set out in paragraph (6) of subsection (c). This results from the fact that section 353 quite clearly establishes "good faith" as a condition only to write-downs and other primary servicing techniques referred to in subsection (a) of that section, and not as a condition to net recovery buyouts set out in subsection (c)(6).

---

[1] The "good faith" provision is found in section 353(b)(2) of the Consolidated Farm and Rural Development Act, 7 U.S.C. 2001. Section 353 was added to that Act by section 615(a) of the Agricultural Credit Act of 1987, P.L. 100-233, 101 Stat. 1678, Jan. 6, 1988.

To explain our basis for this position, I set out subsections (a) through (c) of Section 353 below:

"SEC. 353. Debt restructuring and loan servicing

(a) In General.–The Secretary shall modify delinquent farmer program loans made or insured under this title, or purchased from the lender or the Federal Deposit Insurance Corporation under section 309B, to the maximum extent possible–

(1) to avoid losses to the Secretary on such loans, with priority consideration being placed on writing-down the loan principal and interest (subject to subsections (d) and (e)), and debt set-aside (subject to subsection (e)), whenever these procedures would facilitate keeping the borrower on the farm or ranch, or otherwise through the use of primary loan service programs as provided in this section; and

(2) to ensure that borrowers are able to continue farming or ranching operations.

(b) Eligibility.–To be eligible to obtain assistance under subsection (a)–

(1) the delinquency must be due to circumstances beyond the control of the borrower, as defined in regulations issued by the Secretary;

(2) the borrower must have acted in good faith with the Secretary in connection with the loan as defined in regulations issued by the Secretary;

(3) the borrower must present a preliminary plan to the Secretary that contains reasonable assumptions that demonstrate that the borrower will be able to–

(A) meet the necessary family living and farm operating expenses; and

(B) service all debts, including those of the loans restructured; and

(4) the loan, if restructured, must result in a net recovery to the Federal Government, during the term of the loan as restructured, that would be more than or equal to the net recovery to the Federal Government from an involuntary liquidation or foreclosure on the property securing the loan.

(c) Restructuring Determinations.–

(1) Determination of Net Recovery.–In determining the net recovery from the involuntary liquidation of a loan under this section, the Secretary shall calculate–

(A) the recovery value of the collateral securing the loan, in accordance with paragraph (2); and

(B) the value of the restructured loan, in accordance with paragraph (3).

(2) Recovery Value.--For the purpose of paragraph (1), the recovery value of the collateral securing the loan shall be based on--

(A) the amount of the current appraised value of the property securing the loan; less

(B) the estimated administrative, legal, and other expenses associated with the liquidation and disposition of the loan and collateral, including--

(i) the payment of prior liens;

(ii) taxes and assessments, depreciation, management costs, the yearly percentage decrease or increase in the value of the property, and lost interest income, each calculated for the average holding period for the type of property involved;

(iii) resale expenses, such as repairs, commissions, and advertising; and

(iv) other administrative and attorney's costs.

(3) Value of the Restructured Loan.--

(A) In General.--For the purpose of paragraph (1), the value of the restructured loan shall be based on the present value of payments that the borrower would make to the Federal Government if the terms of such loan were modified under any combination of primary loan service programs to ensure that the borrower is able to meet such obligations and continue farming operations.

(B) Present Value.--For the purpose of calculating the present value referred to in subparagraph (A), the Secretary shall use a discount rate of not more than the current rate on 90-day Treasury bills.

(4) Notification.--Within 60 days after receipt of a written request for restructuring from the borrower, the Secretary shall--

A) make the calculations specified in paragraphs (2) and (3);

(B) notify the borrower in writing of the results of such calculations; and

(C) provide documentation for the calculations.

(5) Restructuring of Loans.--If the value of the restructured loan is greater than or equal to the recovery value, the Secretary shall, within 45 days after notifying the borrower of such calculations, offer to restructure the loan obligations of the borrower under this title through primary loan service programs that would enable the borrower to meet the obligations (as modified) under the loan and to continue the farming operations of the borrower. If the borrower accepts such offer, within 45 days after receipt of notice of acceptance, the Secretary shall restructure the loan accordingly.

> (6) Termination of Loan Obligations.--If the value of the restructured loan is less than the recovery value and if, within 45 days after receipt of the notification described in paragraph (4)(B), the borrower pays (or obtains third-party financing to pay) the Secretary an amount equal to the recovery value, the obligations of the borrower to the Secretary under the loan shall terminate, except that the Secretary may require, as a condition of such termination of loan obligations, that the borrower enter into an agreement with the Secretary if the borrower sells or otherwise conveys the real property used to secure such loan within 2 years after the date of such agreement. Any such agreement shall provide for the recapture of part or all of the difference between the recovery value of the loan and the fair market value (on the date of such agreement) of the property securing the loan if the borrower realizes a gain on the sale or conveyance over the amount of the recovery value of the loan. In no event shall any such agreement provide for recapture of an amount that exceeds the difference between such recovery value and the fair market value of the property securing the loan on the date of such agreement."

As I believe an examination of these subsections shows, they are carefully drawn and detailed, and establish precise limits that the agency must respect. The "good faith" test applies by its terms to eligibility to obtaining "assistance under subsection (a),". Subsection (a), in turn, defines the relief that can be obtained under that subsection as including "writing-down the loan principal and interest," "debt set-aside," and "the use of primary loan service programs as provided in this subsection." "Primary loan service program" is further defined (in paragraph (3) of subsection 343(b) of the Consolidated Farm and Rural Development Act)[3] as consisting of:

> "(A) loan consolidation, rescheduling, or reamortization;
> (B) interest rate reduction, including the use of the limited resource program;
> (C) loan restructuring, including deferral, set aside, or writing down of the principal or accumulated interest charges, or both, of the loan; or
> (D) any combination of actions described in subparagraphs (A), (B), and (C)."

The definition set out above does not include net recovery buyouts.

The absence of any mention of net recovery buyouts in the listing of loan service actions to which the "good faith" provision applies is telling, because Congress was so specific in applying the condition to write-downs, set-asides, and the list of loan servicing actions set out in section 343(b)(3). Under the legal principle of expressio unius est exclusio alterius the statute must be construed as precluding the application of the "good faith" condition beyond where Congress chose to stipulate it. When Congress has carefully set out the terms where a condition applies, as in this instance, we do not believe that a court would conclude that the agency could add the condition to another kind of relief spelled out in a different subsection of the same section, even through the use of notice-and-comment rulemaking. Indeed, an attempt to extend the limits of the "good faith" limitation would undoubtedly be challenged judicially, and could result in litigation of the same kind, and having the same effect on the agency's program, as that which the statute was intended to lay to rest.

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[3] This section of the Consolidated Farm and Rural Development Act was added by section 602 of the Agricultural Credit Act of 1987, 7 U.S.C. 1991, P.L. 100-233, 101 Stat. 1665, Jan. 6, 1988. The section lists the sections of the Consolidated Farm and Rural Development Act to which it is to apply, which list includes section 353.

We have been asked whether, in originally arriving at the conclusion set out in this memorandum, this Division considered Congressional intent. The answer is yes, in that the Division reviewed the legislative history of the Agricultural Credit Act of 1987 quite thoroughly, and found no legislative history of the kind that courts consider in reviewing statutes--Committee Reports, changes in draft bills, or floor language--indicating that Congress intended the "good faith" test to apply beyond the limits delineated in subsection (a) of section 353. Specifically, the legislative history indicates no intention to apply the "good faith" test to net recovery buyouts. The version of the present Section 353 considered and adopted in the House of Representatives bill was structured differently from the provision that was eventually enacted, and this precise question thus did not present itself in that chamber.[3] Nor was the relationship between "good faith" and net recovery buyouts referred to in the Senate report issued subsequent to consideration by the Senate Committee on Agriculture--although the section in its present form was constructed while the bill was under consideration there.[4] Finally, we have reviewed the Conference Report and the floor discussion of the bill,[5] again without finding any language on the precise question at issue here.[6]

It has been suggested that the agency could, by regulation, extend the "good faith" test to net recovery buyouts on the theory that, since Congress did not specifically prohibit such a practice, the agency could adopt it. We do not agree that such a rule could be sustained. Judicial decisions have established the general principle that the agency should not impose procedural or substantive limitations on debt relief granted by legislation.[7] Farmers Home Administration's past experience suggests that an attempt to extend this restriction on

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[3] See sec. 202 of H.R. 3030, H.R. Rept. 100-295 on H.R. 3030, Part 1, pages 34-36, setting out the House Committee version of this section as reported out of that Committee.

[4] Senate Rept. 100-230, Calendar No. 452 on S. 1665 at pp. 46, 124, 250.

[5] Floor discussions are reported in numerous pages of the Congressional Record. See 133 Cong. Rec. S11725 (Aug. 7, 1987) through 133 Cong. Rec. S18458 - S18472 (Dec. 19, 1987).

[6] See H.R. Rept. 100-490 on H.R. 3030, setting out section 353 in its present form on pages 115-120. The section-by-section analysis (at page 277) notes that the Senate version of section 353 is similar to that of the House bill except that it adds provisions, inter alia, requiring "good faith" for a borrower to be eligible for "restructuring."

[7] Coleman v. Lyng, 663 F. Supp. 1315, 1324-25 (D. ND 1987), rev'd on other grounds, 864 F.2d 604 (8th Cir. 1988), cert. denied, 58 L.W. 3304 (Nov. 7, 1989). See generally Curry v. Block, 738 F.2d. 1556 (11th Cir. 1984).

"borrower rights" by regulation, in light of the statutory language in this instance, would be most unlikely to succeed.

The second question that you have asked us to address is whether Farmers Home Administration must ignore a borrower's other assets, when the agency has no lien on them, in computing the write-down under the formula established in section 353 of the Consolidated Farm and Rural Development Act. Here our advice has been less definitive, since the considerations are much more complex. One important consideration in the analysis of the situation is that the formula set out in subsection 353(c) of the Act, which--like the rest of the section--is quite specific, does not mention unencumbered assets. Thus the agency has no authority from the Congress to take them into account in computing write-downs. On the other hand, one of the conditions to eligibility for primary loan servicing set out in paragraph (1) of section 353(b) is that the delinquency be "due to circumstances beyond the control of the borrower, as defined in regulations issued by the Secretary". Thus, if the acquisition of other assets can be construed as causing the borrower's delinquency, then the agency would be justified in denying eligibility for write-down. (It should be noted that such a conclusion would, if the borrower's farming operation cannot "cash flow" at net recovery value, make the borrower eligible for net recovery buyout.) In many instances, however, the borrower might be able to make a persuasive showing that the other assets had nothing to do with his delinquency, which was solely attributable to losses from farming operations. The agency could also encounter difficulties if a court were to impose a strict burden of proof of causality on the agency, even in situations where it appeared likely that the purchase of other assets had contributed to a delinquency situation.

If the agency were to decide that a delinquent borrower was not eligible for restructuring because of the existence of other assets, the agency would still be faced with taking legal action to collect its debt. Here State law, to which the agency is subject in suing on its notes or in foreclosing, varies from from one jurisdiction to another. In some States, the agency cannot obtain a non-judicial foreclosure on the assets on which it does have a lien and, at the same time, obtain a deficiency judgement with which it might possibly seize the assets on which it does not have a lien. Another problem that must be considered is the inevitable delay involved with foreclosures and the collection of deficiency judgments. At times, some U.S. Attorneys cannot give such suits a high enough priority that they can be completed within a reasonable time. The situation, of course, would vary from office to office, depending on the U.S. Attorney's workload of criminal and other high-priority matters.

The situation is further complicated by the fact that some "other assets" may be things that some might not consider luxuries--outboard motor boats, small cabins, or collections of salable items such as coins or guns--while others may be substantial ones--such as inherited real property or stock portfolios. Some assets may be income-producing (in which case the income ought to be reflected in the farm and home plan, and thus would reduce the need for a write-down by the same amount that the sale of the asset would generate--a forced sale thus causing a loss of property that a borrower might resist but achieving no net gain for the government), whereas other assets may not be income producing, even though capable of producing income--such as an inherited farm that the borrower has allowed his or her child to operate rent-free. It would be possible to make distinctions between these different factual situations only in the context of notice-and-comment rulemaking.

In sum, the situation is complex factually, and less clear legally, and our advice to Farmers Home Administration is that they may have a legal right to deny write-downs because of these assets under present law in some few instances but probably do not in most instances. We have further advised them that it would be possible to initiate a notice-and-comment rulemaking to explore this issue, but that, in view of possible judicial hostility to agency-initiated restrictions on borrower relief, it would be far preferable to seek specific Congressional guidance through legislation.

One reason that legislation would be preferable is that denying a borrower eligibility for any write-down, which would be the result of regulations based on the theory that the delinquency was not beyond the borrower's control, is less efficient than allowing the agency to effect a partial write-down, taking the assets into account. Whether the delinquency was or was not "beyond the control of the borrower" can be a subjective and emotional issue, difficult for the agency to deal with. Allowing such assets to be considered in computing the write-down--which the agency now does in debt settlement situations--would be simpler, would allow the government a partial recovery significantly sooner, and would generate less legal controversy with borrowers.

In the meantime, the agency has no legally-defensible alternative but to ignore these assets in many instances, and to attempt to persuade borrowers to dispose of assets or make other decisions on a case-by-case basis. We have advised the agency to avoid litigation pending an attempt to seek Congressional clarification, and in any event not to attempt to collect unencumbered assets, even in the most serious cases, without first checking with the local Office of the General Counsel staff for a review of the situation in light of the laws of the State in which the borrower is located. In view of the agency's experience in the litigation referred to in footnote 7, above, we believe that the litigation that could result from attempts to limit eligibility could be complex and time-consuming, and quite possibly counterproductive to the government's interests, even if the agency were ultimately successful.

We are aware that the result of our advice is, as Under Secretary Vautour stated in his testimony of January 25, 1990, before the Subcommittee on Conservation, Credit and Rural Development, that "the agency is forced to ignore other assets such as other farm or nonfarm real estate and other nonliquid assets." Under Secretary Vautour's statement correctly reflects this Office's position on this issue, as we believe that the agency has no present legally-sound alternative but to ignore these unencumbered assets in most instances.

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

Honorable Kent Conrad
Chairman, Subcommittee on
  Agricultural Credit
Committee on Agriculture,
  Nutrition and Forestry
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to the 11 questions you presented in your letter of February 26, 1990. As you will see, we have responded as completely as possible, although some information will be submitted later for the record and some is not available.

I hope this information is helpful to you and the Committee.

Sincerely,

ROLAND R. VAUTOUR
Under Secretary
  for Small Community
  and Rural Development

RESPONSES TO SENATOR CONRAD'S FEBRUARY 26, 1990, REQUEST

1. QUESTION

The number of borrowers who have been offered buyouts but have not yet accepted the offer whom the Office of the General Counsel has determined have acted in bad faith with regard to FmHA.

RESPONSE

This information is not readily available. We are conducting a field survey and will provide the information for the record.

2. QUESTION

The total amount of debt writtendown or writtenoff has been reported as individuals' income to the Internal Revenue Service. If available, please provide information on how many individuals are involved and how many are insolvent.

RESPONSE

Principal writeoffs/writedowns reported to the Internal Revenue Service were $1,257,774,147.26. We do not capture borrower insolvency, however, a recent study completed last fiscal year, of a sampling of FmHA borrowers Nationwide indicated that 18 percent of FmHA borrowers were insolvent.

3. QUESTION

Of the total debt writedown and writeoff which has occurred under the Agricultural Credit Act to date, please provide a breakdown of the dollar amount by principal, interest and total, and percentage of the total which is attributed to each of the following loan programs: Economic Emergency, Disaster Emergency, Farm Operating, Farm Ownership, and other programs. Please include the average amount of writedown and writeoff for each of these programs.

RESPONSE

The average amount of writeoffs/writedowns are not available by loan program. The percentage of debt writtendown/writtenoff per loan program is:

Farm Ownership	12.8%
Operating	18.2%
Emergency	48.5%
Economic Emergency	19.5%
Other	1.0%
Total	100.0%

Following is the amount of principal and interest writeoffs/writedowns by major loan program.

NET RECOVERY (3Q - WRITEOFF)

	Interest	Principal	Total
FARM OWNERSHIP	20,154,179.60	130,263,744.00	150,417,923.60
OPERATING	29,612,064.35	142,555,882.07	172,167,946.42
EMERGENCY DISASTER	140,611,960.53	385,522,160.98	526,134,121.51
ECONOMIC EMERGENCY	43,446,381.83	130,542,010.59	173,988,392.42
OTHER	2,376,020.13	8,123,010.48	10,499,030.61
TOTAL NET RECOVERY	236,200,606.44	797,006,808.12	1,033,207,414.56

SHARED APPRECIATION (3R - WRITEDOWN)

	Interest	Principal	Total
FARM OWNERSHIP	4,804,190.81	70,698,997.92	75,503,188.73
OPERATING	6,144,979.99	142,911,184.24	149,056,164.23
EMERGENCY DISASTER	18,304,277.50	309,761,568.27	328,065,845.77
ECONOMIC EMERGENCY	10,706,021.24	158,871,771.18	169,577,792.42
OTHER	377,330.26	6,258,926.34	6,636,256.60
TOTAL SHARED APPRECIATION	40,336,799.80	688,502,447.95	728,839,247.75
GRAND TOTAL	276,537,406.24	1,485,509,256.07	1,762,046,662.31

4. QUESTION

The total debt outstanding before servicing for those borrowers who requested primary loan servicing by principal, interest, and total.

RESPONSE

The amount of debt outstanding for those borrowers who requested primary loan servicing, that are still being processed is not readily available. The "Report on Borrowers with Restructuring Action Short of Writedowns" and The "Summary of Writedown (3R) Transactions" and "Summary of Writeoff (3Q) Transactions" include the unpaid principal and interest amounts before servicing (unpaid principal and unpaid interest columns).

The following are National totals:

	Before Servicing		
For	Unpaid Principal	Unpaid Interest	Total
Loans with Restructuring	$	$	$2,387,301,358
Loans with Writedowns	1,180,230,707	321,358,420	1,501,589,127
Loans with Writeoffs	935,283,698	349,040,657	1,284,324,355
Total	$2,115,514,405	$670,399,077	$5,173,214,840

5. QUESTION

The total delinquency before servicing for those borrowers who applied for loan servicing by principal, interest, and total.

RESPONSE

The delinquency for those borrowers who requested primary servicing and their requests are still being processed by FmHA is not readily available. The "Report on Borrowers with Restructuring Actions Short of Writedowns", "Summary of Writeoff (3Q) Transactions", and the "Summary of Writedown (3R) Transactions" provide the total delinquency before servicing for those borrowers who applied and received loan servicing. Principal and interest breakouts are not available. National totals follow:

For	Amount Delinquent Before Serving
Loans with Restructuring	$408,023,830
Loans with Writeoffs	592,907,617
Loans with Writedowns	445,839,174
Total Delinquent	$1,446,770,621

6. **QUESTION**

The total amount scheduled to be paid over the life of the loans before servicing for those borrowers who received primary loan servicing, by principal, interest, and total.

RESPONSE

The "Report on Borrowers with Restructuring Actions Short of Writedowns," "Summary of Writeoff (3Q) Transactions," and the "Summary of Writedown (3R) Transactions" provide the total amount to be paid over the life of the loan before servicing by state. Principal and interest breakouts are not available. National totals follow:

For	Total to be Paid Over the Life of the Loan Prior to Servicing
Loans with Restructuring	$4,416,451,765
Loans with Writeoffs	5,440,540,904
Loans with Writedowns	2,669,819,817
Total Delinquent	$12,526,812,486

7. **QUESTION**

The total remaining debt after primary loan servicing utilizing rescheduling, reamortization, and writedown of debt, by principal, interest, and total.

RESPONSE

The "Report on Borrowers with Restructuring Actions Short of Writedowns" and the "Summary of Writedown (3R) Transactions" provide the unpaid balances after servicing by state. Debt before and after servicing for loans restructured are identical except for principal and interest distribution on the borrower account. National totals follow:

For	Total Debt After Servicing
Loans with Restructuring	$2,387,301,358
Loans with Writedowns	724,057,786
Total	$3,111,359,144

8. **QUESTION**

The total amount to be paid over the life of the loans after servicing for those borrowers who received primary servicing, by principal, interest, and total.

RESPONSE

The "Report on Borrowers with Restructuring Actions Short of Writedowns" and the "Summary of Writedown (3R) Transactions" provide the amount to be paid over the life of the loans after servicing by state. Principal and interest breakouts are not available. National totals follow:

For	Total to be Paid Over the Life of the Loan After Servicing
Loans with Restructuring	$4,726,760,484
Loans with Writedowns	1,723,370,996
Total	$6,450,131,480

9. **QUESTION**

The present value of the remaining debt after servicing, in principal, interest, and total.

RESPONSE

The "Report on Borrowers with Restructuring Actions Short of Writedowns" and the "Summary of Writedown (3R) Transactions" provide the present value of the amount to be repaid after servicing. Principal and interest breakouts are not available. National totals follow:

For	Present Value
Loans with Restructuring	$2,226,491,948
Loans with Writedowns	747,497,033
Total	$2,973,988,981

10. QUESTION

Total net recovery value of the collateral of all loans restructured to date, including those writtendown and writtenoff.

RESPONSE

The net recovery value (NRV) of collateral for loan writeoffs (3Q) represents the amount of actual cash received. The NRV for loans writtendown (3R) represents the estimated residual value if the property were liquidated. The "Summary of Writeoff (3Q) Transactions" and "Summary of Writedown (3R) Transaction" provide this data. Net recovery values are not captured for loans restructured without a writedown.

The following are National totals:

For	Net Recovery Value
Loans with Writeoffs	$190,685,683
Loans with Writedowns	420,434,067
Total	$611,119,750

11. QUESTION

The percentage of inventory properties sold: Using FmHA direct loans, using FmHA guaranteed loans, through transfer and assumption transactions by contract, and by lump-sum sale.

RESPONSE

This information is not available by the breakout requested. Sales which are financed with guaranteed loans are not identified on our records. They would appear on FmHA's records as a cash sale, since FmHA does not provide the financing. During the period from October 1, 1988, through February 28, 1990, 1,731 Farmer Program properties were sold. FmHA financed 86.7 percent of these sales through credit sales. The remaining 13.3 percent would be cash sales. Partial sales are not included. Inventory properties are not disposed of by transfer and assumption, or contract sales. Lump-sum sales would be considered a cash sale.

Analysis of Impact
# of Processed Transactions
Related to the

Agricultural Credit Act of 1987

As of February 28, 1990

Prepared by:

Department of Agriculture
Farmers Home Administration
Finance Office
Financial and Management Reports Section

Summary of Writeoff (3Q) Transactions

Primary Selection Criteria: Borrowers with writedown transactions processed as of report date.

Data Element	Source	Comments
Number of 3Q	3Q transactions input by the field offices. Data includes the number of writedowns processed to borrower accounts and captured in the equity record.	Only one 3Q can be processed per borrower.
Amount of 3Q	3Q transactions input by the field offices. Data represents the amount of writedowns processed to borrower accounts and is captured from the equity record.	This amount should agree with the writedown amount computed in DALR$. Only one 3Q can be processed per borrower.
Amount Delinquent Prior to 3Q	Loan accounts prior to restructuring per the 2-1-89, RC 616.	The amount of schedule status (amount behind) plus the remaining installments through the life of the loan.
Unpaid Principal Prior to 3Q	Represents the total principal due on all farmer program loans for borrowers who had a 3Q process.	
Unpaid Interest Prior to 3Q	Represents the total interest due on all farmer program loans for borrowers who had a 3Q process.	Computed as follows: 3Q Amount + Net Recovery Amount = Unpaid Principal and Interest - Unpaid Principal as of 2-1-89, RC 616 = Unpaid Interest Prior to 3Q

Summary of Writeoff (3Q) Transactions

Primary Selection Criteria: Borrowers with writedown transactions processed as of report date.

Data Element	Source	Comments
Market Value	Input by the field office from DALR$ and captured in the equity record.	AN No. 1982(1951) dated 9-27-89 instructed field offices to include chattels in the market value reported.
Net Recovery Value	Input by the field office from DALR$ and captured in the equity record.	AN No. 1982(1951) dated 9-27-89 instructed field offices to include chattels in the market value reported. Cash received should equal the net recovery value of collateral. Net recovery buyout payment amount plus the writeoff amount should equal the total unpaid loan balances on DALR$ as of the effective date of writeoff. (Reference AN No. 1974(1951) dated 8-29-89.)
Amount to be Paid Over the Life of the Loan	Loan accounts prior to restructuring per the 2-1-89, RC 616.	The amount of schedule status (amount behind) plus the remaining installments through the life of the loan.

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UNITED STATES DEPARTMENT OF AGRICULTURE
FARMERS HOME ADMINISTRATION
SUMMARY OF WRITEOFF (30) TRANSACTIONS
AS OF 02/28/90

STATE	NUMBER OF 30	AMOUNT OF 30	AMOUNT DELINQUENT	UNPAID PRINCIPAL	UNPAID INTEREST	MARKET VALUE	NET RECOVERY VALUE	AMOUNT TO BE PAID OVER LIFE OF LOAN
ALABAMA	124	21,553,280	11,745,927	20,305,580	6,242,826	9,133,603	4,995,126	41,202,421
ARIZONA	8	3,124,419	2,213,422	2,052,790	1,241,472	266,800	169,843	3,042,379
ARKANSAS	229	64,309,606	42,015,701	49,987,808	21,947,061	16,670,961	7,625,263	249,692,248
CALIFORNIA	34	13,625,252	10,055,874	11,099,008	5,963,424	8,090,981	3,437,180	69,403,199
COLORADO	50	9,343,772	3,869,113	8,528,201	2,771,676	6,346,985	1,406,107	26,873,699
DELAWARE	1	502,406	209,451	451,909	150,612	124,400	100,115	876,056
FLORIDA	39	19,656,969	12,193,254	14,455,251	6,990,723	3,909,884	1,789,005	29,082,287
GEORGIA	247	72,706,871	52,432,986	55,729,831	29,523,943	25,449,221	12,546,903	272,557,497
IDAHO	120	28,077,820	14,162,076	22,669,271	9,481,987	16,122,094	4,073,438	84,966,676
ILLINOIS	136	17,720,084	8,027,444	16,334,657	4,972,906	13,321,302	3,587,479	114,743,790
INDIANA	174	33,737,329	15,388,734	29,464,851	11,556,375	18,497,183	7,223,897	173,913,615
IOWA	115	18,645,490	8,007,849	18,613,991	5,019,649	12,164,794	4,988,150	58,881,611
KANSAS	73	9,660,016	4,773,878	8,559,840	3,234,126	5,501,132	2,133,950	49,779,558
KENTUCKY	126	22,101,924	9,879,550	22,213,621	6,702,879	13,172,671	6,814,576	85,914,732
LOUISIANA	558	129,318,408	79,434,060	100,852,505	38,874,596	32,460,065	10,408,693	778,059,036
MAINE	47	13,256,149	9,552,631	10,283,030	4,776,023	2,547,916	1,802,904	28,461,774
MARYLAND	16	1,704,733	1,104,493	1,875,682	529,385	1,201,840	700,334	3,997,818
MICHIGAN	164	37,685,017	16,501,280	31,930,813	11,340,540	23,704,198	5,586,336	421,205,688
MINNESOTA	518	89,497,907	42,368,812	78,859,926	27,207,422	50,142,711	16,569,461	392,634,158
MISSISSIPPI	353	90,132,676	60,541,940	74,880,864	29,550,969	27,269,953	14,299,157	741,909,148
MISSOURI	256	43,964,675	16,964,044	41,031,000	12,322,913	29,673,513	9,989,238	223,016,625
MONTANA	66	18,174,851	6,847,911	16,570,513	4,568,434	63,157,569	2,964,096	111,388,165
NEBRASKA	115	21,939,749	11,350,924	19,937,325	8,269,856	12,820,161	6,267,432	67,806,935
NEVADA	1	247,026	132,869	201,174	32,530	238,450	46,678	499,862
NEW MEXICO	15	1,754,602	1,019,893	1,869,357	563,742	1,127,629	678,497	23,219,563
NEW YORK	38	6,024,313	4,071,299	5,253,148	2,072,423	3,040,777	1,301,258	60,672,542
NORTH CAROLINA	113	24,134,805	15,251,723	20,865,500	8,843,960	9,644,054	5,574,655	47,485,598
NORTH DAKOTA	297	59,327,204	23,552,397	52,206,130	16,785,858	43,482,585	9,664,724	270,418,399
OHIO	66	15,123,166	8,094,382	13,180,987	5,181,206	8,229,676	3,239,027	32,467,331
OKLAHOMA	227	42,089,247	19,681,014	35,656,119	12,894,417	19,628,913	6,461,289	201,615,037
OREGON	44	10,417,554	5,555,284	8,678,470	3,621,022	6,967,616	1,381,938	20,032,808
PENNSYLVANIA	19	3,578,452	2,038,823	3,132,158	1,214,892	1,323,650	768,598	16,075,606
PUERTO RICO	1	93,065	93,760	86,140	77,870	105,000	70,945	415,315
SOUTH CAROLINA	49	16,798,625	6,822,284	9,132,130	3,209,050	3,162,125	1,542,555	48,404,630
SOUTH DAKOTA	166	28,201,658	13,589,448	29,382,097	8,922,259	18,272,847	10,102,698	91,797,636
TENNESSEE	76	12,170,526	5,949,831	12,401,680	3,686,617	6,438,999	3,917,771	31,094,992
TEXAS	164	45,993,514	20,612,882	37,141,395	14,470,033	14,352,576	5,623,914	175,039,625
UTAH	8	1,685,076	571,993	1,693,516	385,081	731,500	394,121	4,200,353
VIRGINIA	47	7,518,903	5,363,505	6,604,720	2,758,884	3,409,294	1,844,701	22,645,931
WASHINGTON	19	3,868,665	2,600,742	4,026,881	1,670,053	6,151,412	1,178,269	28,746,969
WEST VIRGINIA	4	101,434	92,216	99,563	40,784	49,140	38,913	224,995
WISCONSIN	203	32,387,160	9,007,510	29,721,320	8,226,498	22,053,735	5,560,658	321,976,003
WYOMING	32	7,134,214	3,759,508	6,662,946	1,787,079	12,582,653	1,315,811	14,038,594
TOTAL	5156	1073,638,672	592,907,617	935,283,698	349,040,657	572,842,568	190,685,683	5440,540,904

Summary of Writedown (3R) Transactions

Primary Selection Criteria: Borrowers with writedown transactions processed as of report date.

Data Element	Source	Comments
Number of 3R	3R transactions input by the field offices. Data is captured from the equity record and represents the number of writeoffs processed to borrower accounts.	Transactions pending are not included.
Amount of 3R	3R transactions input by the field offices. Data represents the amount of writedowns processed to borrower accounts and is captured from the equity record.	This amount should agree with writedown amount computed in DALR$. Only one 3R can be processed per borrower. Transactions pending are not included.
Unpaid Principal Prior to 3R	Represents the total principal due on all farmer program loans for borrowers who had a 3R process.	Includes debt set-aside and outstanding cost items. Computed by subtracting principal credits from the original loan amount prior to rescheduling.
Unpaid Interest Prior to 3R	Represents the total interest due on all farmer program loans for borrowers who had a 3R process.	Computed as follows: New loan balance - Unpaid Principal Prior to Reschedule = Capitalized Interest + Noncapitalized Interest = Total Unpaid Interest prior to rescheduling
Market Value	3R transactions input by the field office and processed to the equity record.	Only one 3R can be processed per borrower.

Summary of Writedown (3R) Transactions

Primary Selection Criteria: Borrowers with writedown transactions processed as of report date.

Data Element	Source	Comments
Net Recovery Value	3R transactions input by the field office and processed to the equity record.	Comparative field only; represents net recovery value if a writeoff had processed instead of a writedown. AN No. 1934(1951) dated 6-7-89, Attachment 1, page 2 of 4. Only one 3R can be processed per borrower.
Total Debt After Servicing	Computed field. Rescheduled loan amount less amount of 3R.	
Amount of Delinquency Before Servicing	RC 616, Insured Active Borrowers Delinquent, as of 2-1-89 (after maturing the 1-1-89 installment).	
Total Amount To Be Repaid Before Servicing	Loan account information prior to restructuring.	The amount of schedule status (amount behind) plus the remaining installments through the life of the loan.
Total Amount To Be Repaid After Servicing	Loan account information after restructuring.	The amount of schedule status (amount behind) plus the remaining installments through the life of the loan. Equals amount before servicing for loans having no restructuring action taken.
Present Value After Servicing	Computed field. Present value based on average 8.25 percent Treasury bill rate in effect for 1-1-89 to 3-31-89.	Assumes equal installments over the life of the loan.

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UNITED STATES DEPARTMENT OF AGRICULTURE
FARMERS HOME ADMINISTRATION
SUMMARY OF WRITEDOWN (SR) TRANSACTIONS

AS OF 02/28/90

STATE	NUMBER OF SR	AMOUNT OF SR	UNPAID PRINCIPAL	UNPAID INTEREST	MARKET VALUE	NET RECOVERY VALUE	TOTAL DEBT AFTER SERVICING
ALABAMA	63	8,609,187.90	13,258,217.77	2,362,992.06	4,815,840.00	4,990,344.00	7,012,021.93
ARIZONA	22	10,007,671.20	11,150,795.38	5,785,077.51	4,905,107.00	3,082,451.00	6,086,201.69
ARKANSAS	127	27,943,600.50	34,548,796.71	11,550,184.65	15,930,407.00	12,094,792.00	18,155,322.80
CALIFORNIA	31	11,553,125.89	13,063,220.39	6,287,166.14	7,322,960.00	5,425,679.00	7,797,268.64
COLORADO	36	5,942,362.84	10,330,602.89	2,672,475.32	7,842,054.00	4,072,843.00	7,080,715.37
CONNECTICUT	1	202,257.30	458,137.58	70,016.74	243,750.00	199,876.00	252,497.02
DELAWARE	1	223,585.27	318,053.74	254,369.86	315,000.00	243,609.00	349,338.31
FLORIDA	48	6,670,493.80	8,492,974.35	3,229,084.78	3,444,238.00	2,388,831.00	5,045,565.33
GEORGIA	110	20,636,291.62	31,211,571.41	14,231,213.37	15,268,143.00	9,994,524.00	18,800,493.16
IDAHO	101	24,965,488.82	37,221,013.79	10,455,958.66	22,554,941.00	11,[illegible]242.00	22,711,483.03
ILLINOIS	170	22,019,073.64	35,714,513.63	8,600,722.04	19,567,301.00	13,[illegible]370.00	21,756,162.03
INDIANA	238	35,651,434.64	51,615,248.70	16,865,770.06	32,925,129.00	18,778,191.00	32,829,584.12
IOWA	145	15,793,329.88	29,788,479.77	6,176,105.24	19,975,644.00	15,211,600.00	20,171,255.13
KANSAS	100	9,416,472.21	17,915,200.42	4,482,615.07	12,900,213.00	8,129,698.00	12,981,343.28
KENTUCKY	196	19,087,058.23	39,095,944.37	6,716,036.34	18,553,037.00	14,372,463.00	20,125,522.40
LOUISIANA	198	44,882,808.05	48,585,051.57	15,554,377.49	149,923,415.00	8,207,387.00	19,257,161.51
MAINE	14	2,300,996.07	3,230,531.02	723,583.37	1,164,727.00	941,507.00	1,853,117.70
MARYLAND	6	171,384.22	863,052.60	243,230.76	1,088,835.00	537,960.00	934,899.14
MASSACHUSETTS	1	69,848.49	50,500.00	38,973.92	10,100.00	8,910.00	19,625.43
MICHIGAN	202	38,071,644.89	50,540,335.12	13,142,292.33	35,877,247.00	10,853,346.00	31,010,982.56
MINNESOTA	491	63,224,070.44	97,565,711.29	22,750,637.13	52,743,498.00	24,257,903.00	57,091,677.93
MISSISSIPPI	196	44,306,762.40	54,840,756.08	17,872,381.30	23,993,701.00	15,546,490.00	28,354,374.98
MISSOURI	242	28,592,830.59	51,016,357.08	10,093,791.98	30,918,943.00	28,940,327.00	32,517,318.47
MONTANA	77	22,071,390.79	28,191,434.70	10,022,202.82	17,444,256.00	10,925,561.00	16,142,240.73
NEBRASKA	150	19,847,140.37	34,287,991.31	10,405,059.26	21,799,391.00	18,121,224.00	24,846,594.18
NEVADA	3	775,938.72	1,079,416.76	445,833.63	403,300.00	344,103.00	749,255.87
NEW HAMPSHIRE	1	2,308.87	35,453.10	640.11	6,140.00	5,456.00	33,754.32
NEW MEXICO	12	1,305,342.70	2,791,174.03	555,826.97	1,402,790.00	918,561.00	2,041,650.30
NEW YORK	32	3,937,211.10	7,057,579.55	2,098,053.97	5,419,579.00	3,758,123.00	6,418,422.36
NORTH CAROLINA	73	12,967,658.80	20,548,316.50	5,776,183.42	10,006,286.00	6,754,316.00	13,356,835.06
NORTH DAKOTA	340	48,096,432.48	77,587,925.70	18,932,488.79	54,182,833.00	24,524,599.00	48,423,982.01
OHIO	28	4,968,470.38	7,062,941.54	1,782,126.32	3,648,204.00	2,143,893.00	3,936,591.98
OKLAHOMA	282	60,928,638.04	90,989,082.77	20,053,017.13	48,720,770.00	29,427,092.00	58,114,001.86
OREGON	45	7,814,605.90	10,638,090.59	3,337,857.56	7,429,570.00	3,154,616.00	6,161,280.25
PENNSYLVANIA	24	3,452,334.04	6,063,538.02	1,107,313.23	3,666,150.00	1,889,027.00	4,315,517.21
PUERTO RICO	1	1,643.93	14,882.33	872.90	10,600.00	.00	14,111.25
SOUTH CAROLINA	45	9,304,210.13	13,941,708.72	3,676,986.55	5,700,000.00	2,398,394.00	8,254,485.14
SOUTH DAKOTA	361	47,014,242.10	81,070,449.84	20,655,370.19	49,516,020.00	30,569,967.00	54,717,577.93
TENNESSEE	95	15,609,958.56	25,682,646.01	6,698,404.72	12,700,890.00	10,290,307.00	16,771,172.77
TEXAS	136	20,534,480.43	38,817,565.74	7,308,686.03	18,179,162.00	11,281,704.00	25,351,866.14
UTAH	9	598,775.01	1,371,939.21	231,683.84	972,290.00	1,816,262.00	1,004,849.04
VIRGINIA	42	7,622,301.10	12,090,889.53	3,218,810.55	6,736,553.00	5,061,095.00	8,293,338.98
WASHINGTON	40	6,861,382.70	12,666,338.79	3,176,460.23	9,054,503.00	5,032,983.00	8,481,416.32
WEST VIRGINIA	10	1,338,733.65	2,149,135.50	403,453.03	930,340.00	802,290.00	1,213,854.85
WISCONSIN	231	24,620,331.99	44,298,331.96	8,608,552.39	25,873,375.00	11,895,679.00	28,280,552.36
WYOMING	37	8,701,127.07	13,095,105.97	4,074,510.92	8,110,974.00	4,247,972.00	8,468,489.82
TOTAL	4879	777,531,340.72	1180,230,706.05	321,358,419.98	794,818,506.00	420,434,067.00	724,057,785.91

UNITED STATES DEPARTMENT OF AGRICULTURE
FARMERS HOME ADMINISTRATION
SUMMARY OF WRITEDOWN (3R) TRANSACTIONS
AS OF 02/28/90

STATE	AMOUNTS PRIOR TO RESTRUCTURING AMOUNT DELINQUENT	AMOUNTS PRIOR TO RESTRUCTURING BEFORE SERVICING	AMOUNT TO BE PAID OVER LIFE OF LOAN AFTER SERVICING	AMOUNT TO BE PAID OVER LIFE OF LOAN PRESENT VALUE
ALABAMA	4,914,944.56	25,062,776.30	16,408,903.00	8,038,571.44
ARIZONA	9,763,246.07	25,071,197.25	15,411,115.00	6,426,285.43
ARKANSAS	17,932,371.72	80,543,647.32	45,306,467.41	18,814,416.09
CALIFORNIA	6,880,384.42	33,204,558.78	30,752,019.00	13,700,271.47
COLORADO	3,482,228.17	24,010,140.49	19,206,718.00	8,027,899.72
CONNECTICUT	40,912.00	693,372.91	414,610.00	219,397.93
DELAWARE	336,805.61	970,592.61	1,139,677.00	408,935.97
FLORIDA	5,142,281.69	19,650,402.94	12,653,572.00	6,667,029.67
GEORGIA	22,712,382.92	70,728,919.94	44,178,521.39	18,534,199.42
IDAHO	13,543,630.96	87,700,461.63	52,238,879.00	22,619,551.95
ILLINOIS	16,844,990.97	83,669,478.21	52,052,499.40	22,397,621.45
INDIANA	20,804,578.74	136,388,133.59	79,783,751.28	32,115,790.15
IOWA	7,741,819.96	69,865,966.12	48,887,194.00	20,615,468.01
KANSAS	5,767,860.59	45,707,817.46	30,788,785.00	12,322,877.97
KENTUCKY	9,708,251.45	95,181,080.45	63,065,265.00	25,137,374.21
LOUISIANA	29,547,594.65	98,227,053.93	45,440,346.08	22,997,777.41
MAINE	1,802,432.87	5,192,313.01	3,899,034.00	1,975,018.44
MARYLAND	345,130.83	1,730,243.27	1,958,586.00	836,268.36
MASSACHUSETTS	65,850.00	89,473.92	35,670.00	20,047.37
MICHIGAN	17,400,974.07	112,424,331.88	70,584,821.00	31,045,910.56
MINNESOTA	30,528,753.81	215,813,489.85	125,350,826.00	53,311,434.90
MISSISSIPPI	31,414,520.12	115,557,861.83	63,532,572.00	29,059,333.22
MISSOURI	14,011,478.97	121,944,542.12	92,918,604.93	37,738,892.96
MONTANA	12,485,575.26	73,230,704.99	44,012,192.00	18,230,969.71
NEBRASKA	12,450,798.56	85,080,580.98	65,271,303.00	25,563,418.61
NEVADA	648,621.90	2,446,483.63	2,011,424.00	993,588.22
NEW HAMPSHIRE	3,000.00	36,093.21	44,985.00	26,367.91
NEW MEXICO	1,143,103.02	6,039,568.14	5,162,550.60	2,288,770.37
NEW YORK	3,801,461.09	15,941,777.98	14,184,191.96	6,367,432.23
NORTH CAROLINA	7,716,234.65	49,874,463.97	31,334,973.42	13,257,441.49
NORTH DAKOTA	22,981,993.67	185,071,401.92	114,320,764.24	49,121,446.96
OHIO	2,405,518.93	18,141,631.77	9,176,203.00	4,171,054.28
OKLAHOMA	36,604,226.50	188,254,477.61	124,087,347.50	60,432,218.86
OREGON	4,800,415.98	21,969,529.78	17,368,165.00	7,381,452.48
PENNSYLVANIA	1,724,511.64	11,904,824.18	8,720,680.00	3,984,891.49
PUERTO RICO	11,984.00	15,755.23	32,127.00	27,474.14
SOUTH CAROLINA	5,860,918.79	27,969,786.85	17,703,959.00	8,902,906.60
SOUTH DAKOTA	20,557,451.18	179,705,019.00	123,550,472.78	53,258,354.84
TENNESSEE	8,453,068.23	64,456,402.38	45,852,415.00	18,522,207.22
TEXAS	11,112,801.71	75,157,134.63	91,201,918.92	24,956,470.20
UTAH	246,041.61	4,287,081.04	3,022,227.00	1,267,605.82
VIRGINIA	4,614,524.01	30,828,820.02	16,748,701.00	8,069,984.25
WASHINGTON	4,721,079.08	31,236,022.93	22,288,374.00	9,577,383.87
WEST VIRGINIA	410,228.38	4,979,838.80	3,509,605.00	1,440,505.14
WISCONSIN	7,670,396.76	90,849,542.65	64,290,669.00	27,708,149.28
WYOMING	4,603,182.28	30,296,367.45	19,609,304.00	8,838,548.01
TOTAL	445,839,174.18	2669,819,817.01	1723,370,995.91	747,447,033.01

Report on Borrowers with Restructuring Actions Short of Writedowns
Processed 1-1-89 Through the Report Date

Primary Selection Criteria: Borrowers with rescheduling/reamortization/consolidation processed 1-1-89 through the report date and not having a writedown (3R) or writeoff (3Q) transaction processed. (Data is not currently available on conservation easements, deferrals, or single family housing equity transactions.)

Data Element	Source	Comments
Number of Borrowers	Criteria: Borrower with loan(s) rescheduled/reamortized/consolidated from 1-1-89 to report date.	
Unpaid Balances Prior to Restructuring	Computed field. Represents the total principal and interest due on all farmer program loans for borrowers who had any loan restructured between 1-1-89 and the report date. The unpaid principal and the interest was computed as of the effective date of the restructuring.	Includes loans rescheduled, reamortized, or consolidated.
Amount of Delinquency Before Servicing	RC 616, Insured Active Borrowers Delinquent, as of 2-1-89 (after maturing the 1-1-89 installment).	Includes all loans for borrowers with any loan rescheduled/reamortized/consolidated.
Total Amount To Be Repaid Before Servicing	Loan account information prior to restructuring.	The amount of schedule status (amount behind) plus the remaining installments through the life of the loan. Includes all loans for borrowers with any loan rescheduled/reamortized/consolidated.

Report on Borrowers with Restructuring Actions Short of Writedowns Processed 1-1-89 Through the Report Date

Primary Selection Criteria: Borrowers with rescheduling/reamortization/consolidation processed 1-1-89 through the report date and not having a writedown (3R) or writeoff (3Q) transaction processed. (Data is not currently available on conservation easements, deferrals, or single family housing equity transactions.)

Data Element	Source	Comments
Total Amount To Be Repaid After Servicing	Loan accounts after restructuring.	The amount of schedule status (amount behind) plus the remaining installments through the life of the loan. Equals amount before servicing for loans having no restructuring action taken. Includes all loans for borrowers with any loan rescheduled/reamortized/consolidated.
Present Value After Servicing	Computed field. Present value based on average 8.25 percent Treasury bill rate in effect for 1-1-89 to 3-31-89.	Assumes equal installments over the life of the loan.

UNITED STATES DEPARTMENT OF AGRICULTURE
FARMERS HOME ADMINISTRATION
RESCHED/CONSOLID LOANS SHORT OF WRITEDOWNS
AS OF 02/28/90

		AMOUNTS PRIOR TO RESTRUCTURING		AMOUNT TO BE PAID OVER LIFE OF LOAN		
STATE	NBR OF BORROWERS	UNPAID BALANCES	AMOUNT DELINQUENT	BEFORE SERVICING	AFTER SERVICING	PRESENT VALUE
ALABAMA	265	33,020,529.00	5,419,550.95	60,527,370.98	64,480,575.08	31,590,920.48
ARIZONA	50	12,042,039.85	3,599,510.31	26,603,378.37	25,832,097.12	10,975,379.75
ARKANSAS	573	72,345,911.73	12,853,968.07	134,845,893.55	150,758,552.25	70,691,824.33
CALIFORNIA	315	69,202,315.61	15,527,958.26	135,068,273.53	148,391,653.49	65,577,792.20
COLORADO	164	25,186,699.47	5,273,441.69	44,906,180.03	49,379,946.39	21,909,531.94
CONNECTICUT	23	4,285,573.04	864,911.76	6,533,311.67	7,559,664.00	3,450,685.06
DELAWARE	11	1,506,881.00	246,907.56	1,943,060.41	2,452,514.00	1,130,630.08
FLORIDA	175	25,108,248.06	7,581,448.51	42,034,890.04	47,537,990.41	22,324,329.61
GEORGIA	304	52,439,908.49	14,785,706.39	100,358,264.31	103,344,235.98	47,288,701.47
HAWAII	52	11,384,852.03	1,193,674.76	19,188,933.01	20,803,330.72	8,580,487.97
IDAHO	329	47,759,839.82	8,864,763.58	86,932,395.64	94,248,753.42	43,756,273.59
ILLINOIS	675	75,981,471.66	12,331,710.86	147,580,515.53	152,684,097.88	70,647,160.65
INDIANA	341	59,197,626.12	8,724,935.06	104,691,203.17	108,197,498.27	46,943,640.09
IOWA	962	115,683,225.62	16,289,972.53	205,407,924.20	220,516,801.80	103,743,482.17
KANSAS	374	47,119,303.08	6,680,867.76	93,367,425.95	94,459,622.66	42,325,174.45
KENTUCKY	564	64,249,405.16	7,749,154.78	131,741,720.65	137,235,233.22	59,987,541.66
LOUISIANA	588	69,148,362.34	13,079,982.37	124,914,265.08	126,597,718.21	69,286,468.97
MAINE	134	23,330,489.68	3,069,941.37	39,955,885.54	45,768,193.00	21,561,729.19
MARYLAND	104	12,470,576.09	2,400,250.70	20,962,056.32	24,575,569.51	11,575,305.38
MASSACHUSETTS	39	6,591,459.77	747,455.46	13,622,236.50	18,183,468.24	7,640,437.37
MICHIGAN	478	67,078,179.16	12,252,739.71	107,241,973.68	118,709,915.14	60,499,750.52
MINNESOTA	648	75,033,685.33	12,552,859.05	125,504,797.22	137,674,908.73	68,206,291.31
MISSISSIPPI	635	90,902,348.33	24,030,732.55	160,020,326.24	159,215,886.13	82,824,734.63
MISSOURI	555	71,425,532.87	11,338,552.71	146,775,322.14	150,003,814.36	66,381,030.56
MONTANA	417	77,400,422.60	12,964,252.94	152,273,665.55	152,483,694.06	71,469,041.38
NEBRASKA	488	64,109,395.19	11,760,613.90	127,500,315.98	139,611,868.35	61,693,565.44
NEVADA	14	2,458,609.65	661,566.98	4,067,083.57	8,385,242.18	3,340,542.13
NEW HAMPSHIRE	10	1,269,756.96	84,603.02	2,702,918.23	2,420,286.94	1,069,789.29
NEW JERSEY	65	10,083,553.07	2,522,367.95	16,043,444.16	18,215,769.75	9,209,691.21
NEW MEXICO	106	20,376,795.33	4,026,185.52	35,262,171.34	38,660,144.78	17,928,132.42
NEW YORK	357	55,130,115.65	10,169,541.57	89,199,953.14	100,641,006.21	48,747,426.73
NORTH CAROLINA	336	43,364,398.82	7,283,350.88	72,338,587.48	79,188,404.08	37,494,372.38
NORTH DAKOTA	1107	162,903,645.96	23,267,578.24	314,379,786.78	324,812,119.52	156,483,037.13
OHIO	346	56,204,820.43	6,774,921.42	111,928,792.31	113,238,062.40	52,056,375.15
OKLAHOMA	711	110,105,550.06	20,310,122.88	209,986,265.67	213,327,754.17	101,775,480.22
OREGON	124	22,523,635.07	4,384,714.83	41,866,755.59	45,722,122.60	19,304,471.59
PENNSYLVANIA	311	42,481,215.14	4,486,667.64	77,408,886.72	85,351,240.36	40,907,637.72
PUERTO RICO	134	11,940,902.17	1,570,323.75	21,267,293.92	23,349,123.98	10,050,376.09
RHODE ISLAND	6	463,459.77	20,240.00	915,974.24	937,112.00	334,663.67
SOUTH CAROLINA	232	39,372,348.02	9,275,088.90	77,331,103.09	77,653,796.59	34,066,380.69
SOUTH DAKOTA	800	90,970,398.85	15,189,240.77	163,383,960.96	190,249,214.09	88,090,626.79
TENNESSEE	705	93,197,676.20	16,799,630.06	193,530,055.88	204,290,198.80	91,296,671.41
TEXAS	980	139,560,275.36	25,460,400.97	242,748,165.03	255,944,534.84	130,958,066.11
UTAH	134	19,982,916.88	2,155,424.21	36,276,927.35	43,677,946.09	18,730,433.61
VERMONT	39	5,191,756.06	261,879.57	10,541,950.32	13,433,399.65	5,852,342.44
VIRGINIA	256	32,434,880.87	5,181,968.82	67,357,115.71	71,283,879.49	33,710,454.06
WASHINGTON	227	38,772,439.16	6,854,137.21	85,497,105.41	89,104,461.13	42,373,094.13
WEST PAC TERR	1	84,917.02	10,180.00	251,901.00	201,541.00	59,608.32
WEST VIRGINIA	134	14,057,392.47	1,906,461.82	29,742,880.63	31,634,738.02	14,321,437.71
WISCONSIN	562	86,900,618.38	5,806,853.00	120,289,381.22	145,740,019.84	70,566,518.72
WYOMING	95	15,784,605.04	1,559,056.40	36,416,507.86	31,585,734.75	14,201,969.62
TOTAL	17090	2387,301,357.54	403,023,829.57	4410,451,764.90	4720,760,484.27	2220,491,948.19

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

APR 09 1990

The Honorable Kent Conrad
Chairman, Subcommittee on
Agricultural Credit
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of February 9, 1990, regarding the pooling of Farmers Home Administration (FmHA) guaranteed loans by the Federal Agricultural Mortgage Corporation (Farmer Mac). Farmer Mac has reviewed and concurs with this response. Your questions have been listed below and the responses follow.

1. Please provide me with the legislative language which your office believes is necessary to implement a FmHA secondary market.

RESPONSE: The following changes are necessary in order for Farmer Mac to establish a secondary market for FmHA guarantees.

Amend Subsection 8.0(3) of the Farm Credit Act (12 U.S.C. 2279aa) by designating all of the subsection after the word "means" as a paragraph "(A)", by striking the period after the phrase "Section 8.5" and inserting in lieu thereof, "or", and by adding a new paragraph "(B)" to read as follows: "(B) the Corporation and any affiliate thereof, but only with respect to qualified loans as defined in subsection 8.0(9)(B) of this section."

Amend Subsection 8.0(9) of the Farm Credit Act (12 U.S.C. 2279aa) by redesignating the text of the existing subsection as a new paragraph "(A)", by redesignating existing paragraphs (A), (B), and (C) as subparagraphs "(i)", "(ii)" and "(iii)" of new subsection (A), and by adding a new paragraph "(B)" to read as follows: ", or (B) is the portion of a loan guaranteed by the Secretary of Agriculture pursuant to the provisions of the Consolidated Farm and Rural Development Act, title III of P.L. 87-128, as amended, provided that, the provisions of subsections (b) through (f), inclusive, of section 8.6 and sections 8.7, 8.8 and 8.9 of this Act shall not apply to such portions of loans guaranteed by the Secretary or to obligations, pools, or securities representing interests in or obligations backed by pools of obligations relating to such portions of loans guaranteed by the Secretary, and provided further that, such portions of loans guaranteed by the Secretary, shall be deemed to meet all standards for qualified loans for all purposes of this Act."

2. I understand one of OMB's main concerns with the mandated FmHA secondary market is the question of whether the borrowers' payments which are to flow from the lender to the investor are public or private money. The Small Business Administration's (SBA) secondary market considers these monies to be private. Why would the FmHA secondary market differ? Please provide me with USDA's legal opinion on this matter if you believe these monies are public.

RESPONSE: FmHA originally proposed a secondary market structure which is similar to that used by SBA. After analyzing the FmHA proposal, the USDA Office of the General Counsel (OGC) raised the public money concern and suggested FmHA obtain an opinion from the Treasury Department. Treasury declined to answer this question. While the Agency has not formally received an OGC opinion, OGC indicates that there still is a concern over the way funds backed by the Federal Government could be handled by private entities, as in FmHA's proposed original structure, without raising a public money question.

3. I understand that OMB believes that the guarantee of timely payment of principal and interest will require outlays that are on-budget. Please provide me with OMB's legal opinion regarding the budgetary status of these payments.

a. SBA has established a reserve fund, created by earnings from the float of payments, which is used when necessary to make these timely payments. Why wouldn't a similar reserve be possible for the FmHA secondary market?

RESPONSE: OMB did not provide a formal legal opinion on this issue. FmHA originally proposed a reserve fund very similar to the existing SBA reserve fund. OMB's determination that the activity be on-budget was not based on the source of funding for the timely payments. Rather, OMB viewed the Secretary's timely payment guarantee as creating a new, additional liability of the Government, equal to the full amount of the loan sold in the secondary market.

While working with OMB, we came to the conclusion that the secondary market structure utilized by SBA was not the best for FmHA. It would have resulted in a small, unique market at substantial administrative cost to the taxpayer, but afforded little opportunity for the level of bond issues needed to gain market efficiency and reduce interest rates to borrowers. We ultimately determined that combining the market with Farmer Mac was in the best interests of the borrowers, the lenders, and the taxpayers.

b. Alternatively, would it be possible to charge a small fee to fund a reserve to be used to make these payments?

RESPONSE: FmHA's original proposal provided for a reserve fund that was funded both by float earnings and a small fee levied on the cash flow. As indicated above, OMB's concern did not focus on the source of funding.

c. Given OMB's belief that the guarantee of timely payment of principal and interest must be on-budget, how do you expect Farmer Mac to address this problem?

RESPONSE: Unlike FmHA, Farmer Mac was established by Congress as a Government Sponsored Enterprise (GSE). As such, it is recognized by OMB as a non-Federal entity and, hence, not subject to the rules on budget scoring.

4. I am very concerned that FmHA's secondary market, which was to be operational in July 1988, is still not running.

a. If FmHA were to implement this program, what changes would need to be made in the existing regulations, which currently allow the sale of guaranteed loans? How long would it take FmHA to implement this program?

RESPONSE: Existing regulations allow the lender to sell the guaranteed portion of a loan. The proposed legislative change would allow the purchase of individual guaranteed portions and placement of them into pools, thus providing secondary market activities for FmHA guaranteed loans within the Farmer Mac structure, which would not require changes to existing FmHA regulations. This is one of the advantages of this proposed structure; that it allows the new secondary market to become operational as soon as Farmer Mac is physically able to accommodate FmHA loans. Farmer Mac estimates it would be ready to accept FmHA loans within 180 days after the necessary legislation is passed. If FmHA were to attempt to establish its own secondary market, significant regulations would have to be published, providing the two issues of public money and budget treatment can be resolved. FmHA has now worked 2 years without success on these issues. As we stated in our response to Question 3 (a), above, we believe it would be a mistake to attempt to establish a separate market for FmHA guaranteed loans only.

b. If Congressional action is necessary to provide Farmer Mac with the statutory authority to administer this program, when will you commit to having this secondary market in operation?

RESPONSE: The market can be made operational very soon after enactment of the necessary amendment, probably within 3-6 months. The most time-consuming task will be contacting the lenders and holders of FmHA loans and identifying those who may be interested in selling the guaranteed portions of the loans. This process can begin before enactment of the amendment if it appears that the probability of legislative change is high enough to justify the commitment of people and resources by FmHA and Farmer Mac.

5. Through transferring FmHA's secondary market function to Farmer Mac, is it the Secretary's intent to reduce FmHA's role in the credit markets?

RESPONSE: No. It is the Secretary's intent to have the widest possible access to credit for agriculture at the lowest possible interest rates. Combining the FmHA market with Farmer Mac will accomplish this, as it will create a successful secondary market for all farm loans, implement Congressional intent and meet the Secretary's goal. This procedure will minimize administrative costs to taxpayers, minimize confusion among participants, and should provide impetus to lenders to become involved in the FmHA guaranteed loan program. Farmers and ranchers will be the beneficiaries of the efficiencies of one market.

FmHA will continue to fulfill its mission as the lender of last resort to farmers. FmHA believes this participation with Farmer Mac enhances, rather than diminishes, its ability to accomplish that mission.

6. The Secretary is responsible to Congress if problems occur in this secondary market and has the authority and is responsible for taking corrective action. However, if Farmer Mac is given the responsibility to administer this secondary market program for the Secretary, how would responsibility day-to-day and program administration be divided?

In particular, how would FmHA handle delinquent accounts?

RESPONSE: FmHA will continue to handle delinquent accounts in the same manner that they are now handled. That is, the lender remains responsible for servicing the loan until payoff or liquidation, no matter who is holding the guaranteed portion of the loan. If a payment on the loan is 60 days or more past due, the holder (Farmer Mac in the case of pooled loans) can request the lender to repurchase the guaranteed portion of the loan. If the lender refuses, FmHA will purchase the guaranteed portion. FmHA is proposing no changes in its delinquent account servicing requirements. As far as farmers/borrowers are concerned, there will be no change for them if the proposed structure is adopted, except lowered interest rates resulting from a more efficient market.

7. During consideration of the Agricultural Credit Act, one of the arguments for establishing an FmHA secondary market was that FmHA could profit by issuing the certificates themselves, through the receipt of fees. What returns would be available through the implementation of a secondary market? Please include a discussion on the receipt of premiums from the above par value sale of certificates.

RESPONSE: FmHA never envisioned creating a secondary market structure that would generate profits for the Agency. FmHA expected to cover costs, but beyond that, efficiencies of the market should go to reducing interest rates for farmers and ranchers. If demand for certificates is such that they sell at a premium, this should translate into strong demand on lenders to sell guaranteed portions of FmHA loans. Ultimately, these market forces should enhance credit availability at reduced costs to farmers and ranchers.

The Memorandum of Understanding (MOU) with Farmer Mac allows that entity to retain up to 25 basis points to cover its costs of promoting and administering an FmHA secondary market. This fee is subject to review after 2 years to insure it is adequate, but not excessive, to cover costs and risks.

8. Do you intend to seek a structural change in the secondary market program as set forth in the Agricultural Credit Act of 1987 if FmHA is allowed to transfer the secondary market function to Farmer Mac?

RESPONSE: No. The only significant change will be to authorize Farmer Mac to issue securities backed by pools consisting of the guaranteed portions of FmHA guaranteed loans assembled by Farmer Mac. This new authority will provide Farmer Mac a power which it does not appear to have under existing law. No other structural change is necessary.

9. If Farmer Mac implements this program, will it serve as a second guarantor, as it does with Farmer Mac pooled loans, guaranteeing the timely payment of principal and interest on these loans, or simply as a servicer and marketer?

RESPONSE: Farmer Mac will be the guarantor of timely payment of principal and interest only on securities backed by the guaranteed portions of FmHA loans. It will not guarantee the underlying loan or share any risk in the loan.

Farmer Mac will also act as the pooler and will market the securities through one or more underwriters. It will not service the loans; the lenders will continue to do this, but will remit collections on the loans to Farmer Mac, or a trustee designated by Farmer Mac.

10. Will Farmer Mac have any financial risk in implementing this secondary market?

RESPONSE: Farmer Mac will have the following financial risks:

- A "pipeline" risk on loans which Farmer Mac has committed to buy before the pool has been closed and the securities priced. A shift in interest rates during this period could cause losses. Farmer Mac will attempt to minimize the period of time during which it may be exposed to this risk and can substantially offset the risk by hedging;
- The "timing" risk between the date the payment is due on the securities and the date upon which Farmer Mac recovers from the borrower or FmHA on any loans which are delinquent. If Farmer Mac's cost of funds needed during such period exceeds the rate of interest recoverable on the loans, there could be negative spreads. Farmer Mac will mitigate this risk to the greatest extent possible: (1) by requiring lenders to make advances to cover late payments and (2) by making use of current FmHA regulations, which provide for delinquent loans held by a third party to be repurchased by the lender or by FmHA once the delinquency exceeds 60 days; and
- Under the Federal Securities laws, including the Securities Act of 1933, Farmer Mac, as issuer, will have obligations of and risks with respect to due diligence and full disclosure to the securities investors. Because of the guarantees backing the loans pooled, it is unlikely that actual losses will be incurred by Farmer Mac on the basis of these duties. Responding fully to its obligations under the securities laws, however, will require a substantial commitment of time and resources by Farmer Mac.

While there are risks, the opportunity also exists for Farmer Mac to profit if the shifts in interest rates are in their favor.

11. Please go through step by step how Farmer Mac would implement FmHA('s) secondary market:

a. How would a loan guaranteed by FmHA that is held by a bank be pooled in order for Farmer Mac to issue a security?

RESPONSE: The guaranteed portion of the loan would be purchased by Farmer Mac pursuant to a commitment and a loan purchase agreement, and the appropriate documents delivered to Farmer Mac or a trustee designated by Farmer Mac, at or about the same time that the securities are sold. The proceeds of the sale of securities would be used to pay the expenses of issuance and the agreed-upon price of the guaranteed portion of the loan.

b. After pooling, how will payments actually be made to the investors? Will Farmer Mac make payments as due to investors, expecting to be reimbursed by the lenders or will lenders make payments through Farmer Mac to the investor?

RESPONSE: The payments will be made by Farmer Mac, or by a trustee designated by Farmer Mac. The lenders will remit payments on the loans to Farmer Mac or its trustee.

c. If a loan that was pooled defaults or is delinquent, how are payments made to the investor?

RESPONSE: Payments are made from funds available to Farmer Mac or the trustee, including reserves held by the trustee (if any), advances from the lender and Farmer Mac's own loss reserves.

d. If a borrower prepays his guaranteed loan, what would be the effect on the pool which includes that loan and on the investor?

RESPONSE: Prepayments of principal will-be paid to the investors. The timing of the payments and their allocation among investors depends upon how the securities are structured. The simplest form of structure is a pass through, in which all payments of principal on the loans, scheduled and unscheduled, are promptly paid out pro rata to all investors. Many issues have more complex structures, in which there are two or more classes of securities. Payments of principal, scheduled and unscheduled, can be allocated to one class until it is paid in full, and then to the next class and so forth. The more complex structures will add value to the transaction with resulting economic benefits to lenders and borrowers.

e. If Farmer Mac were to implement this program, would they assign the same amount of risk to FmHA pools as to Farmer Mac pools?

RESPONSE: No. In some ways the Farmers Home Loan program is less risky because of the FmHA guarantee that payment will be made ultimately on the guaranteed portions of the loans. There are, however, risks to Farmer Mac which are not present in its regular program. Farmer Program loans are made to borrowers who cannot obtain credit through normal channels and thus cannot obtain loans eligible for the regular program, which has rigorous underwriting, appraisal and diversity standards.

12. The Memorandum of Understanding between USDA and Farmer Mac states that Farmer Mac shall receive fees not to exceed 25 basis points of the outstanding balance. If Farmer Mac is responsible in the short run for making guaranteed timely payments, will these fees be adequate to cover potential shortfalls in receipts in the short run resulting from the need to make good on this guarantee, particularly since Farmer Mac is authorized to receive up to 50 basis points for its own pools? I am concerned that Farmer Mac will have to rely on its line of credit with the Treasury to cover these short run shortfall(s).

RESPONSE: Farmer Mac's guarantee fee of 25 basis points in its regular program was computed after subjecting hypothetical pools of loans to "stress tests" which were based upon available agricultural credit data from the period 1965-1988. Under all these scenarios Farmer Mac had sufficient reserves to cover delinquencies and defaults and never had to borrow from any outside sources, including the Treasury. For the reasons stated in answer to the last part of question 11, above, the risks under the FmHA program, although different in kind, are not more severe in degree. Farmer Mac's own cash reserves will almost certainly be enough to cover the period between payout on the securities and collection from FmHA under its guarantee. Since the guarantee is backed by the full faith and credit of the Federal Government, Farmer Mac, even if its reserves were insufficient, could borrow funds to bridge this gap from commercial lenders and would not need to resort to the Treasury.

It should also be noted that the fee for the FmHA program is not only a guarantee fee but also compensates Farmer Mac for the work of pooling the loans, issuing and marketing the securities, registering the securities with the Securities and Exchange Commission (SEC), administering the pool and other duties, obligations and business risks which it will assume. The amount of the fee will be evaluated after 2 years to insure it is adequate to meet Farmer Mac costs, but is not excessive.

13. If FmHA determines invalid a particular loss claim submitted by a guaranteed loan originator on a delinquent or foreclosed loan which was sold on the secondary market, who would be responsible for making payment to the investor? If Farmer Mac is responsible, who will reimburse it for this payment?

RESPONSE: Farmer Mac, as holder of the guarantee, will not be at risk in case the lender has failed in the servicing of the loan and has not jeopardized the guarantee. As presently occurs under existing regulations, FmHA will purchase the guaranteed portion of the loan from Farmer Mac, as holder, and seek collection from the lender.

14. What effect does the selling of the loans under the secondary market have on FmHA's budget?

RESPONSE: The sale of loans in the Farmer Mac structured secondary market will have no direct effect on FmHA's budget. However, by selling their loan originations in the secondary market, individual lenders theoretically will be able to support a much larger portfolio of loans to farmers and ranchers. This should result in increased availability of credit to rural residents at lower costs.

There may be an indirect, but positive, effect on the budget over the long-term. An efficient secondary market may reduce interest rates and, ultimately, the risks of farm loans. Reduced interest rates will also translate into reduced subsidy costs when FmHA implements a subsidized guaranteed loan program in FY 1991.

a. Does it remove any liability, thereby allowing FmHA to regenerate new loans or guarantees?

RESPONSE: Secondary market sales would not remove any FmHA liability, allowing FmHA to regenerate new loans or guarantees. FmHA's loan authority levels are established annually by Congress.

15. If Farmer Mac is allowed to implement this secondary market, will FmHA or Farmer Mac perform the central collection of registration information from all participating market makers for all loans and pool certificates sold under the secondary market as required by the Agricultural Credit Act?

RESPONSE: Farmer Mac will collect the data and report to FmHA.

16. Please assess the benefits and costs of requiring Farmer Mac to use the regular Government procurement process to find a fiscal transfer agent, and of keeping the loan pooling for FmHA secondary market and Farmer Mac separate operations.

RESPONSE: Farmer Mac was designed to perform fiscal and transfer agent responsibilities in-house and has already contracted with Security Pacific National Bank to act as the Trustee, custodian of documents and related functions for all Farmer Mac pools. Security Pacific was selected by Farmer Mac after a Request for Proposals (RFP) was distributed to a number of potential candidates for the job, written proposals were received and evaluated, and oral presentations were made by several organizations and evaluated by Farmer Mac. On the basis of this procedure, Security Pacific was found to be the most qualified candidate and was awarded the contract as Trustee.

In specific response to your questions, the "regular procurement process" requires the procuring entity to comply with the procedures set forth in the Competition in Contracting Act of 1984 (Public Law 98-369, Title VII, hereinafter called (CICA), the Federal Acquisition Regulations (48CFR, hereinafter called (FAR) and other Federal statutes and regulations applicable to the particular goods or services which are being purchased. Because the activities of a fiscal transfer agent involve a significant amount of computer work or automated data processing (ADP) within the meaning of the Brooks Act (40 USC 759), the procurement would probably have to be done through the General Services Administration (GSA), unless GSA were willing to grant a delegation of procurement authority. Either way, a significant amount of time and money would be spent before an RFP could be prepared and sent to prospective offerors.

The FAR requires the RFP to follow a certain format and to contain numerous standard Government contract clauses (see 48 CFR 52). An unsuccessful offeror could file a bid protest, which would automatically stop the procurement and which, under the Brooks Act, would be tried before the GSA Board of Contract Appeals, which reviews every aspect of the procurement *de novo* and gives little if any preference to the decisions of the contracting officer. (See *Lanier Business Products, Inc.* GSBCA 7702-P, 85-2, BCA, p. 18,033.) Even if the procurement were ultimately upheld, the costs of delay and of preparing and trying the bid protest case would run into tens of thousands of dollars.

In summary, the costs of procurement under the regular Government process are significantly higher than those incurred in normal commercial transactions including the specific procedures already followed by Farmer Mac in selecting its pool Trustee. Farmer Mac follows the usual business practices of seeking to purchase goods and services from the lowest responsible offeror, including, where appropriate, the preparation of RFPs and the conduct of competitive negotiations. The benefits of these practices are at least equal to those obtained under the procedures mandated by CICA, FAR, the Brooks Act and other statutes and regulations applicable to Federal procurement.

With specific reference to the proposal under review, the pooling of FmHA loan guarantees by Farmer Mac simply involves a Government Sponsored Enterprise going into a related business. The legislative changes required do not add new requirements for procuring goods or services nor diminish any requirements or exemptions that presently affect Farmer Mac's operation.

FmHA guaranteed loans will be segregated into their own separate pools, and not commingled with non-FmHA loans. This will be done because of the differences in the underlying characteristics of FmHA and non-FmHA loans. FmHA guarantees are extended to borrowers who are not eligible for private credit. The underwriting criteria for non-FmHA loans is much stricter, and the borrowers' financial condition is healthier. However, from the investors' viewpoint, FmHA loans are equally, or more, "safe" due to the Full Faith and Credit guarantee on the underlying loan. The differences in borrower characteristics will probably translate into differences in loan default and prepayment rates between the two types of pools. From marketing, promotion, and efficiency standpoints, it is necessary to keep the different loan pools separate and distinct, within the one unified structure.

Note: the incoming letter had no questions numbered 17 through 21.

22. Please assess the benefits and costs of pooling Business and Industry loans and FmHA housing loans.

RESPONSE: An active secondary market for individual B&I guarantees already exists and since these loans are so large, there is less need for pooling to promote that market.

Regarding the FmHA guaranteed housing loan program proposed for FY 1991, a secondary market will be needed, but it would be inefficient to develop a separate market for FmHA loans that would compete with already well established secondary markets for housing loans. FmHA has been visiting with Ginnie Mae, Fannie Mae, and Freddie Mac, and anticipates that its new housing guarantees can trade efficiently in existing secondary markets for housing.

Please advise if you have additional questions or wish to discuss the proposed legislation in greater detail.

Sincerely,

ROLAND R. VAUTOUR
Under Secretary
for Small Community
and Rural Development